

ORIGINAL

STATE OF INDIANA

INDIANA UTILITY REGULATORY COMMISSION

PETITION OF INDIANA-AMERICAN)
WATER COMPANY, INC. FOR)
AUTHORITY TO INCREASE ITS RATES) CAUSE NO. 44022
AND CHARGES FOR WATER AND)
SEWER UTILITY SERVICE AND FOR)
APPROVAL OF NEW SCHEDULES OF) APPROVED:
RATES AND CHARGES APPLICABLE)
THERE TO)

JUN 06 2012

ORDER OF THE COMMISSION

Presiding Officers:

Carolene Mays, Commissioner

Jeffery A. Earl, Administrative Law Judge

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FINAL ORDER

On May 2, 2011, Indiana-American Water Company, Inc. ("Petitioner," "Indiana-American," or "Company") filed its Petition and Notice of Intent to File in Accordance with Minimum Standard Filing Requirements ("Petition") with the Indiana Utility Regulatory Commission ("Commission"), seeking authority to increase its rates and charges for water and sewer utility service and for approval of new schedules of rates and charges applicable thereto. Petitioner's notice of its intent to file in accordance with the Commission's rules on minimum standard filing requirements ("MSFRs") was given pursuant to 170 IAC 1-5.

Pursuant to notice and as provided in 170 IAC 1-1.1-15, the Commission held a Prehearing Conference at 11:00 a.m. on June 9, 2011, in Hearing Room 224, 101 West Washington Street, Indianapolis, Indiana. Proofs of publication of the notices of the Prehearing Conference were incorporated into the record and placed in the official files of the Commission. Petitioner, the Indiana Office of Utility Consumer Counselor ("OUCC"), the Town of Schererville ("Schererville"), and the City of Crown Point ("Crown Point") participated at the Prehearing Conference. On June 16, 2011, the Commission issued a Prehearing Conference Order in this Cause. The following parties filed petitions to intervene, which the Commission granted: Schererville; Crown Point; the Indiana-American Industrial Group ("Industrial Group"); the City of West Lafayette ("West Lafayette"); and ArcelorMittal Burns Harbor LLC ("ArcelorMittal").

Pursuant to notice published as required by law, the Commission convened an Evidentiary Hearing at 9:30 a.m. on August 22, 2011, in Hearing Room 222, 101 West Washington Street, Indianapolis, Indiana. The hearing continued on August 23, 26, and 30. Proofs of publication of the notice of the hearing were incorporated into the record and placed in the official files of the Commission. During the Evidentiary Hearing, Indiana-American presented its case-in-chief and offered its witnesses for cross-examination. In addition, the Commission took administrative notice of the following Orders: *Indiana-American Water Co.*, Cause No. 43899, 2010 Ind. PUC LEXIS 355 (IURC Oct. 14, 2010) ("Preapproval Order"); *Indiana-American Water Co.*, Cause No. 43680, 2010 Ind. PUC LEXIS 155 (IURC April 30, 2010) ("2010 Rate Order"); *Indiana-American Water Co.*, Cause No. 43187, 2007 Ind. PUC LEXIS 293 (IURC Oct. 10, 2007) ("2007 Rate Order"); *Indiana-American Water Co.*, Cause No. 42520, 2004 Ind. PUC LEXIS 351 (IURC Nov. 18, 2004) ("2004 Rate Order"); *Indiana-American Water Co.*, Cause No. 42029, 2002 Ind. PUC LEXIS 432 (IURC Nov. 6, 2002) ("2002 Rate Order"); *Indiana-American Water Co.*, Cause No. 40703, 1997 Ind. PUC LEXIS 429 (IURC Dec. 11, 1997) ("1997 Rate Order"); and *Indiana-American Water Co.*, Cause No. 40103, 1996 Ind. PUC LEXIS 126 (IURC May 30, 1996) ("1996 Rate Order").

Pursuant to Ind. Code § 8-1-2-61(b), The Commission held public field hearings on: August 17, 2011, in the City of West Lafayette; August 18, 2011, in the City of Gary, the largest municipality in Petitioner's service area; and August 29, 2011, in the City of Jeffersonville. At each hearing, members of the public provided oral and written testimony, which the Presiding Officers admitted into the Record.

The Evidentiary Hearing continued from December 5-8, 2011. The OUCC and Intervenor presented their respective cases-in-chief and offered their witnesses for cross-

examination. In addition, Petitioner presented its rebuttal evidence and offered its rebuttal witnesses for cross-examination. In addition, the Commission took administrative notice of the following Orders: *Indiana-American Water Co.*, Cause No. 43991, 2011 Ind. PUC LEXIS 128 (May 11, 2011) (“Warsaw AFUDC Order”); *Dep’t of Waterworks of the Consolidated City of Indianapolis*, Cause No. 43645, 2011 Ind. PUC LEXIS 30 (IURC Feb. 2, 2011); *Bd. of Dirs. for Utils. of the Dep’t of Pub. Utils. of the City of Indianapolis*, Cause No. 42767, 2007 Ind. PUC LEXIS 254 (IURC Aug. 29, 2007); *Bd. of Dirs. for Utils. of the Dep’t of Pub. Utils. of the City of Indianapolis*, Cause No. 39066, 1992 Ind. PUC LEXIS 168 (IURC Jun. 10, 1992); *Muncie Water Works Co.*, Cause No. 34571, 1981 Ind. PUC LEXIS 246 (Pub. Serv. Comm’n of Ind. Sept. 16, 1981) (“Muncie Remand Order”). The Commission also took administrative notice of Indiana-American’s Report of Financing filed on November 4, 2010, in Cause No. 43767 and the direct testimony of Gregory T. Guerrettaz on behalf of Crown Point filed on October 27, 2009, in Cause No. 43680.

Having considered the evidence presented in this proceeding and the applicable law and being duly advised, the Commission finds:

1. **Notice and Jurisdiction.** Due, legal, and timely notice of the Petition filed in this Cause was given and published by Petitioner as required by law. Proper and timely notice was given by Petitioner to its customers summarizing the nature and extent of the proposed changes in its rates and charges for water and sewer service. Due, legal, and timely notices of the Prehearing Conference and the other public hearings in this Cause were given and published as required by law. Petitioner is a “public utility” within the meaning of that term in Ind. Code § 8-1-2-1(a)(2) and is subject to the jurisdiction of the Commission in the manner and to the extent provided by the laws of the State of Indiana. Accordingly, this Commission has jurisdiction over Petitioner and the subject matter of this proceeding.

2. **Petitioner’s Characteristics.** Indiana-American, a subsidiary of the American Water Works Company, Inc. (“American Water”), is a public utility corporation organized under the laws of the State of Indiana and is engaged in the provision of water utility service to the public in and around numerous communities and counties throughout the State of Indiana. Petitioner also provides sewer utility service in Wabash and Delaware Counties. Petitioner has charter power and authority to engage in the business of providing such water and sewer utility service. Petitioner renders water and sewer utility service by means of utility plant, property, equipment, and related facilities owned, leased, operated, managed, and controlled by it, which are used and useful for the convenience of the public in the production, treatment, transmission, distribution, and sale of water for residential, commercial, industrial, public authority, and sale-for-resale purposes, for the provision of public and private fire service, and for the provision of sewer service. Petitioner provides utility service to approximately 284,600 customers.

3. **Existing Rates.** Petitioner’s existing basic rates and charges for water and sewer service were established pursuant to the 2010 Rate Order. Subsequently, the Commission approved a Distribution System Improvement Charge (“DSIC”) in *Indiana-American Water Co.*, Cause No. 42351 DSIC 6, 2010 Ind. PUC LEXIS 361 (IURC Oct. 20, 2010). As a result, Petitioner’s current rates are approximately 3% higher than those approved in the 2010 Rate Order.

4. **Relief Requested.** Petitioner originally requested a 10.48% rate increase. Prior to the

August 22 hearing, Petitioner filed supplemental direct testimony and exhibits, reflecting the updated rate base permitted by 170 IAC 1-5-5(3)(B) and Paragraph 2 of the Prehearing Conference Order, and revised its request to a 9.76% rate increase. Petitioner also proposed to continue its transition to single tariff pricing ("STP"), by moving the Warsaw and West Lafayette districts from the Area Two tariff rate to the Area One tariff rate. The Mooresville, Winchester, and Wabash districts would remain in the Area Two tariff rate. Petitioner proposed to further reduce the differential between the Area One and Area Two Commodity Charges and to move the eight remaining municipalities that have not yet adopted ordinances pursuant to Ind. Code § 8-1-2-103 to fire protection surcharges by meter size in lieu of directly billed hydrant charges. Finally, Petitioner requested approval of a 10% depreciation rate for American Water's Business Transformation Project ("BT")

5. **Test Year.** As provided in the Prehearing Conference Order, the test year to be used for determining Petitioner's actual and pro forma operating revenues, expenses, and operating income under present and proposed rates is the twelve (12) months ended December 31, 2010, adjusted for changes that are fixed, known, and measurable for ratemaking purposes and that will occur within twelve (12) months following the end of the test year. The financial data for this test year, when adjusted for changes as provided in the Prehearing Conference Order, is a proper basis for fixing new rates for Petitioner and testing the effect thereof.

6. **Overview.** Alan J. DeBoy, President of Indiana-American, provided an overview of Petitioner's case and identified the most significant drivers of the need for a rate increase. Mr. DeBoy stated that three major categories of changes have occurred since Petitioner's last general rate case: 1) Indiana-American has added substantial capital additions that are not reflected in Petitioner's DSIC, which impact the necessary after-tax return and depreciation expense; (2) Indiana-American's customers are using less total water, which has caused Petitioner's pro forma revenues to be significantly below what was authorized by the 2010 Rate Order and DSIC 6; and (3) higher cost of equity.

7. **Petitioner's Rate Base.**

A. **Original Cost.** In its case-in-chief, Petitioner first presented its utility plant in service balances as of December 31, 2010. Petitioner updated those balances to the June 30, 2011, actual balances pursuant to 170 IAC 1-5-5(4). Petitioner also updated its rate base to reflect one major project referred to as the Warsaw Water Treatment Plant ("Warsaw WTP"), which was identified in the Petition and was also the subject of the Preapproval Order. Estimates of Petitioner's investment were included in Petitioner's case-in-chief and the amount to be included in rate base does not exceed such estimates. Monthly investment updates were filed and the Warsaw WTP was declared to be used and useful at least ten business days before the final evidentiary hearing. The cost of the Warsaw WTP was more than one percent of Petitioner's proposed rate base.

Petitioner proposed a net original cost rate base as of June 30, 2011, adjusted for the cost of the Warsaw WTP, of \$731,882,581.

OUCW Witness, Mr. Charles Patrick, proposed to exclude the post-in-service Allowance for Funds Used During Construction ("AFUDC") and deferred depreciation costs related to the

Warsaw WTP from rate base. OUCC Witness, Ms. Margaret Stull proposed a net original cost of \$730,834,216. The OUCC also raised concerns regarding Indiana-American's Capitalization Policy.

(1) **Warsaw WTP Deferred Depreciation and Post-in-Service AFUDC.**

(a) **Petitioner's Position.** Petitioner included pro forma adjustments to its original cost rate base, updated on June 30, 2011, for deferred depreciation and post-in-service AFUDC related to the Warsaw WTP in the amounts of \$525,079 and \$523,286, respectively. These amounts include the estimated accruals through the anticipated date of this Order.

(b) **OUCC's Position.** Mr. Patrick proposed to exclude from rate base the deferred depreciation and post-in-service AFUDC amounts proposed by Petitioner. Mr. Patrick contended that these amounts exceed the estimated costs stated in Petitioner's case-in-chief with respect to the project and include costs incurred after the cutoff date under the MSFRs. He stated that the total cost included in Petitioner's rate base for the Warsaw WTP was \$26,348,365, which is in excess of the \$25.3 million estimate provided in Petitioner's case-in-chief. He asserted that only costs incurred through November 17, 2011, (ten business days prior to the December 5, 2011 hearing) may be included in rate base, and only to the extent that the total costs of the major project do not exceed the estimate provided in Petitioner's case-in-chief. Mr. Patrick stated that Indiana-American is not precluded from continuing to record deferred depreciation and post-in-service AFUDC related to the Warsaw WTP as approved by the Commission in the Warsaw AFUDC Order and can still capitalize the costs to be included in rate base in its next rate case.

(c) **Petitioner's Rebuttal.** Mr. Gary VerDouw responded that Petitioner did include the estimates of the post-in-service AFUDC and deferred depreciation for the Warsaw WTP in its case-in-chief. Mr. VerDouw then explained that Mr. Patrick's position is inconsistent with the Stipulation and Settlement Agreement ("Settlement") approved in the Warsaw AFUDC Order. There, Petitioner sought authority to continue the accrual of post-in-service AFUDC and to defer depreciation on the Warsaw WTP until such time as a rate order is issued including the project in rate base and providing recovery of depreciation expense. Petitioner entered into a Settlement in that case, which provided that Petitioner should be authorized to: (1) record such post-in-service AFUDC and deferred depreciation as a regulatory asset in Account 186, Miscellaneous Deferred Debits; (2) amortize the regulatory asset over the estimated remaining service life of the improvements, commencing on the date of the first rate order; and (3) include the amortization as a recoverable expense and include the unamortized portion of the regulatory asset in Petitioner's rate base for ratemaking purposes.

Mr. VerDouw described Mr. Patrick's position as seeking to imply the word "subsequent" or "ensuing" in the last sentence as a modification to the phrase "rate cases" such that Petitioner would be authorized to accrue the post-in-service AFUDC and to defer depreciation until the first rate order including the plant in rate base; to commence amortization of the regulatory asset on the date of the issuance of the first rate order including the plant in rate base (this case); but only to include the amortization of the regulatory asset as a recoverable

expense and unamortized balance of the regulatory asset in rate base in “subsequent or ensuing rate cases.”

Mr. VerDouw noted those words do not appear anywhere in the Warsaw AFUDC Order or the Settlement, and they are inconsistent with the relief sought in that case. He stated Petitioner is required to commence amortization of the regulatory asset on the date an order is issued in this Cause, but under Mr. Patrick’s view, Indiana-American would not be permitted to commence recovery of the amortization until its next rate case. He pointed out, however, that in Petitioner’s next rate case, it would only be permitted to earn a return on the unamortized balance. According to Mr. VerDouw, Mr. Patrick’s interpretation results in Petitioner forever being denied recovery of a return of or a return on the portion of the regulatory asset which is amortized between the date of an order in this Cause and the date of an order in Petitioner’s next rate case.

Mr. VerDouw contends that this result is illogical. He further noted that in Petitioner’s last rate case, it treated the London Road and West Lafayette improvement projects in the same manner as in this case, which is to include in net original cost rate base the amount of the deferred asset to be accumulated between the in-service dates and the anticipated order date. He stated neither the OUCC nor any intervenor objected to this treatment, which was ultimately approved by the Commission. At the time of the Settlement in Cause No. 43991, there was thus already a practice for dealing with this issue, and Mr. VerDouw asserted that Mr. Patrick’s new interpretation is inconsistent with that practice.

Mr. VerDouw stated that the inclusion of the Warsaw WTP deferred depreciation and post-in-service AFUDC amounts does not violate the rate base cutoff. He cited to the MSFR requirement that the major project be in service by the cutoff of November 17, 2011. Petitioner filed a Verified Certification of In-Service Date on October 12, 2011 stating that the Warsaw WTP was placed in service on September 30, 2011, thus satisfying the in-service requirement of the MSFRs. Mr. VerDouw testified that there is nothing in the rule that indicates the anticipated level of the ensuing regulatory asset cannot be projected to the date of the Commission Order. He stated Mr. Patrick’s interpretation would mean a utility could never recover a return of and a return on the portion of a related regulatory asset that is amortized between rate cases, which Mr. VerDouw contends is unreasonable.

(d) **Commission Discussion And Findings.** In Cause No. 43991, Petitioner and the OUCC entered into a Settlement, which addressed the accounting treatment and recovery of AFUDC and deferred depreciation related to the Warsaw WTP. The Settlement provides that Petitioner may “continue the post-in-service accrual and capitalization of AFUDC and to defer depreciation ... until the date of issuance of a rate order or orders fully including such Improvements in Petitioner’s rate base and including depreciation expense thereon in Petitioner’s recoverable operating expenses” *Warsaw AFUDC Order*, 2011 Ind. PUC LEXIS 128, at *21. In accordance with the Settlement, the Commission authorized Petitioner to:

record such post-in-service AFUDC and deferred depreciation as a regulatory asset in Account 186, Miscellaneous Deferred Debits; to amortize such regulatory asset over the estimated remaining service life of such Improvements, such amortization commencing on the date of the first rate order including such

Improvements in Petitioner's rate base and including depreciation expense thereon in Petitioner's recoverable operating expenses; and to include such amortization as a recoverable expense and to include the unamortized portion of the regulatory asset in Petitioner's rate base in rate cases.

Id., at *19.

The language of the Settlement and the Warsaw AFUDC Order clearly anticipate that the regulatory treatment of AFUDC and deferred depreciation will span multiple rate cases. Petitioner may include in rate base in this Cause only the level of deferred depreciation and AFUDC accrued through the November 17, 2011 major project cut-off date. The portion of the regulatory asset accrued between November 17, 2011, and the effective date of this Order will not be included in Petitioner's rate base until Petitioner's next base rate case. This treatment is consistent with the rate base cutoff date in the MSFR rule.

Therefore, Petitioner's proposed deferred depreciation and post-in-service AFUDC are reduced by \$426,459 and \$416,217, respectively. Petitioner's rate base shall include \$205,689 for deferred depreciation and post-in-service AFUDC related to the Warsaw AFUDC Order.

(2) Capitalization Policy.

(a) OUCC's Position. Mr. Patrick expressed concern regarding Petitioner's capitalization policy. He stated that during the OUCC's field audit, Mr. VerDouw indicated assets with a value of \$1,500 or more were capitalized without taking into effect the useful life or economic value. Petitioner then provided a copy of its capitalization policy, which indicated that assets are not only capitalized based on original cost equal to or greater than \$1,500 but also on whether the asset is trackable and is expected to have a useful life greater than one year. In light of this discovery response, Mr. Patrick voiced a concern that items may have been expensed that meet the capitalization policy and may have been included in rate base.

(b) Petitioner's Rebuttal. In his rebuttal testimony, Mr. VerDouw indicated he had subsequent discussions with Ms. Stull of the OUCC regarding the capitalization policy and provided a copy of the capitalization policy to the OUCC during discovery. The capitalization policy clearly states that Petitioner takes into account useful life or economic value of the assets.

(c) Commission Discussion and Findings. Based on the testimony of Mr. Patrick and Mr. VerDouw, we find that Petitioner's capitalization policy requires that the useful life and economic value of an asset be taken into consideration in addition to the original cost equal to or in excess of \$1,500 when determining whether the asset is capitalized. Further, we find no evidence in the record suggesting that this policy was not applied correctly or that items were improperly included in rate base.

B. Original Cost Rate Base. Based on the evidence presented and the findings and conclusions above, the original cost of Petitioner's water and sewer utility properties used and useful for the convenience of the public is as follows:

<u>Utility Plant in Service</u>	<u>Commission Finding</u>
Plant in Service	\$1,169,706,967
Warsaw WTP Plant	25,049,505
Capitalized Tank Painting	161,558
Deferred Depreciation	3,929,634
Post-In-Service AFUDC	5,805,542
Less: Retirements	<u>1,645,378</u>
Total Plant in Service	\$1,203,007,827
 <u>Accumulated Depreciation</u>	
Utility Plant in Service	\$304,641,774
Capitalized Tank Painting	140,017
Deferred Depreciation	1,311,865
Post-In-Service AFUDC	2,128,216
Less: Retirements	<u>659,072</u>
Total Accumulated Depreciation	<u>\$307,562,800</u>
 Net Utility Plant in Service	\$895,445,027
 <u>Deductions</u>	
Contributions in Aid of Construction	\$106,438,609
Customer Advances for Construction	60,456,340
Capacity Adjustment – Somerset	<u>195,857</u>
Total Deductions	<u>\$167,090,806</u>
 <u>Additions:</u>	
Acquisition Adjustment (Net)	\$446,751
Materials and Supplies (13 Month Average)	<u>1,988,437</u>
Total Additions	<u>\$2,435,188</u>
 Net Original Cost Rate Base	<u>\$730,789,409</u>

C. Reproduction Cost New Less Depreciation.

(1) **Petitioner's Position.** Petitioner's Witness Stacy Hoffman sponsored a study and analysis of the Reproduction Cost New ("RCN") and Reproduction Cost New Less Depreciation ("RCNLD") of the Company's utility plant and equipment used in providing service to the public. Mr. Hoffman expressed the opinion that Indiana-American's plant and systems are in a good state of operating condition, are well maintained, and are used to satisfy the Company's responsibility to provide safe and reliable water utility service.

RCNLD refers to the estimated cost of reproducing existing facilities at current costs, adjusted for the loss in service value (depreciation) reflected in their current condition. The calculation of RCNLD is a two-step process. Mr. Hoffman first determined the cost of constructing, purchasing, or manufacturing new property substantially the same as the old property, using costs at or about the time of the study. This is the RCN portion of the study. The second step is to determine the percent condition of the property. Percent condition measures the

amount of the property's service value that has not been lost due to physical depreciation. The percent condition is then multiplied by the RCN, resulting in the RCNLD, which is a net cost recognizing both the current costs of reproducing the property and the loss of service value of the existing property due to depreciation in the form of wear and tear, obsolescence, and lack of utility.

Mr. Hoffman testified that the purpose of a RCNLD study is to assess the cost to reproduce the existing utility plant in service based on current material and equipment prices and current construction and wage levels. The original cost of a well-planned facility is representative of its value at the time of construction, but the original cost of plant constructed in the past is generally not representative of the RCN or RCNLD due to changes in unit costs caused by inflation and changes in construction practices.

Mr. Hoffman indicated that he used the Trended Original Cost method, as opposed to the Unit Price method, to determine the RCN of Petitioner's property. According to Mr. Hoffman, the Trended Original Cost method is significantly less costly to perform than the Unit Price method and produces a reasonable result. The Company's accounting records provide the necessary detail about original cost by account, sub-account, and vintage year for a Trended Original Cost study. In Mr. Hoffman's opinion, the Trended Original Cost method is reasonable and appropriate for determining the RCN of Indiana-American's property. Mr. Hoffman further compared the results of the RCN against his knowledge of construction costs in the Indiana area and concluded that the index data is valid and reasonable.

The primary source of the trend factors used in Mr. Hoffman's study was the *Handy-Whitman Index of Public Utility Construction Costs for Water Utilities located in the North Central United States* ("Handy-Whitman Indexes"). Mr. Hoffman stated that he also used an index published by the U.S. Bureau of Labor Statistics for some accounts. Mr. Hoffman believed that the Handy-Whitman Indexes are reasonable to use for estimating RCN because are designed for that purpose. Mr. Hoffman indicated that the Handy-Whitman Indexes have been published continuously since 1924 and are well-recognized around the country as suitable for determining the RCN of utility property. Further, Mr. Hoffman noted that, for many years, Petitioner has calculated the RCN of its utility property using the Trended Original Cost method and the Handy-Whitman Indexes and has found the result to be a reasonable and conservative estimate of the cost to reproduce the property at current price levels. Mr. Hoffman's study included land at its original cost because of the expense of obtaining separate land appraisals. Mr. Hoffman stated that he believes this is a conservative assumption of land costs.

Mr. Hoffman determined the RCNLD by deducting depreciation necessary to reflect the current condition of the property from the RCN. Mr. Hoffman calculated the percent condition of Indiana-American's property to be 73.94%. This ratio reflects the complement of the depreciation reserve divided by the utility plant in service on June 30, 2011. Mr. Hoffman's study quantified the RCNLD of Petitioner's used and useful utility plant in service on June 30, 2011, as not less than \$2,098,677,432. Mr. Hoffman stated that his valuation does not include materials and supplies, capitalized tank painting, post-in-service AFUDC, or deferred depreciation.

Mr. Hoffman's study also includes a calculation of the Trended Cost Adjusted for Technological Change. He explained that even though the Handy-Whitman index already captures the effects of technological change through the years, he made a further adjustment based on changes in productivity through the years. Mr. Hoffman's productivity adjustment factor was calculated using historical data from the Bureau of Labor Statistics ("BLS") Major Sector Productivity Costs Index for Output per Hour for Nonfarm Business ("OHNFB") which is available from 1947 through 2010. The 2011 OHNFB was estimated by multiplying the 2010 OHNFB by the sum of one plus the 10 year compounded annual growth rate ("CAGR") of the OHNFB for the ten year period from 2001 through 2010. Because OHNFB is not available prior to 1947, the 64-year CAGR of the OHNFB from 1947 through 2010 was used to estimate the productivity factor for the period from 1884 through 1946. The resulting productivity factor and corresponding adjustment in the RCN for productivity are shown in respective columns in Petitioner's Exhibit SSH-1 as "Sum of Trended Cost Adjusted for Productivity." As shown in Mr. Hoffman's study, the total Trended Cost Adjusted for Technological Change amount is \$1,191,340,954. Mr. Hoffman computed the weighted average age of plant and equipment in the study based on the RCNLD values, arriving at a weighted average age of 14 years.

(2) **OUC's Position.** Mr. Patrick recommended that the Commission give no more weight to Petitioner's RCNLD study than it has given the studies offered in Petitioner's past rate cases. He noted that Mr. VerDouw did not use the RCNLD Study to determine Petitioner's fair value rate base.

(3) **Commission Discussion and Findings.** "This Commission has routinely accepted RCNLD studies into the record and considered [them] as evidence in support of Petitioners' fair value." *South Haven Sewer Works, Inc.*, Cause No. 41903, 2002 Ind. PUC LEXIS 221, at *5 (IURC June 5, 2002). Our supreme court recognized that RCNLD is one of several reasonable valuation methods that can be used in determining fair value, stating:

[T]he courts will not limit the Commission to any one or more methods of valuation, be it prudent investment, original cost, present value, or cost of reproduction. This court has held that cost of reproduction depreciated is a proper item to be considered under the statute in arriving at a fair value figure.

Pub. Serv. Comm'n of Ind. v. City of Indianapolis, 131 N.E.2d 308, 318 (Ind. 1956).

In *Indianapolis Water v. Pub. Serv. Comm'n*, the court explained that a fair value determination by the Commission is not an either/or proposition between original cost and reproduction cost, but derives from consideration of all legitimate value factors. 484 N.E.2d 635, 638-640 (Ind. Ct. App. 1985). Therefore, there are a number of legitimate valuation methods that the Commission should consider in determining fair value, one of which is the RCNLD method. "[R]eproduction cost new less depreciation cannot be disregarded in fixing a valuation for rate making purposes." *Indianapolis Water*, 484 N.E.2d at 640 (quoting *City of Indianapolis*, 131 N.E.2d at 325 (Emmert, J., concurring)). The court indicated that this observation is as pertinent today as in 1956. *Id.* at 640. We will give appropriate weight to the RCNLD of Petitioner's utility plant for purposes of our fair value finding.

D. Update of Prior Fair Value Finding. Mr. VerDouw updated the fair value finding from the 2010 Rate Order for inflation that has occurred since the valuation date and for net investor supplied plant additions that would not have been included in that fair value finding. To implement this methodology, Mr. VerDouw updated the fair value finding from the 2010 Rate Order – \$945,522,592 – for inflation of 2.1% through June 30, 2011, based on the annual inflation taken from Ibbotson SBBI 2011 Classic Yearbook Market Results for Stocks, Bonds, Bills, and Inflation 1926-2010 as published by Morningstar (“Ibbotson Yearbook”). Mr. VerDouw then added the net investor funded plant additions since the 2010 Rate Order to arrive at a total updated fair value estimate of \$1,126,503,364. Mr. VerDouw noted that this procedure is consistent with the procedure used by the Commission in Petitioner’s 1996 Rate Order, the 1997 Rate Order, the 2002 Rate Order, the 2004 Rate Order, and the 2010 Rate Order. No party submitted any evidence in opposition to Mr. VerDouw’s testimony, methodology, or calculations.

Although the Commission accepts Mr. VerDouw’s methodology for calculating the updated prior fair value, it is clear Mr. VerDouw made a calculation error in his inflation adjustment. We adjusted the fair value finding from the 2010 Rate Order of \$945,522,592 for inflation of 2.1% through June 30, 2011. The results is in an adjusted fair value of \$985,651,516. The net investor-funded plant additions from the 2010 Rate Order through the November 18, 2011 rate base cutoff are \$66,234,254. Adding these two amounts, the Commission finds that Petitioner’s updated fair value is \$1,051,885,770.

E. Ultimate Fair Value Finding. Ind. Code § 8-1-2-6 establishes that this Commission shall value a public utility’s property at its fair value. In *Indianapolis Water*, the Indiana Court of Appeals confirmed that a utility should be entitled to earn a fair rate of return on the fair value of its rate base. 484 N.E.2d at 638-640. Further, in its determination of fair value the Commission may not ignore the commonly known and recognized fact of inflation. *Id.* at 640. The Court of Appeals has more recently confirmed that the Commission must authorize rates that provide the utility with the opportunity to earn a fair return on the fair value of its property. *Gary-Hobart Water Corp. v. Ind. Util. Reg. Comm’n*, 591 N.E.2d 649, 653-54 (Ind. Ct. App. 1992); *Office of Util. Consumer Counselor v. Gary-Hobart Water Corp.*, 650 N.E.2d 1201 (Ind. Ct. App. 1995). Based on the evidence of record, we find that the fair value of Indiana-American’s utility property used and useful in the provision of utility service is not less than \$1,051,885,770.

8. Fair Rate Of Return.

A. Cost of Common Equity.

(1) Petitioner’s Position. Mr. Paul R. Moul, Managing Consultant of the firm P. Moul & Associates, presented Petitioner’s cost of equity recommendation. Mr. Moul testified that 11.5% is a reasonable return on equity (“ROE”) cost of equity for Petitioner.

Mr. Moul discussed the risks facing the water utility industry generally and Indiana-American specifically. He noted that the business risk of water utilities has been strongly influenced by water quality concerns, regulations promulgated by the Environmental Protection Agency (“EPA”), and federal statutes. Water companies have experienced increased water

treatment and monitoring requirements and escalating costs in order to comply with increasingly stringent regulatory requirements and must now also address potential threats from terrorists. Mr. Moul indicated that the Company is engaged in a continuing capital expenditure program that is necessary to meet the needs of its customers and to comply with various regulations. Mr. Moul indicated that the Company's total capital expenditures over the next five years will represent approximately 43% of the utility plant in service, net of contributions, on December 31, 2010.

In addition, Mr. Moul testified that Petitioner has been faced with a sustained decline in the average use per residential customer, which has contributed to Petitioner not realizing actual sales as compared with the billing determinants used to set rates. The high fixed costs of water utilities make earnings vulnerable to significant variations when usage fluctuates with weather, the economy, and customer conservation efforts.

For purposes of his analysis, Mr. Moul used average market data from a proxy group of eight water companies (the "Water Group"). The use of average data, rather than individual company data, helps to minimize the effect of extraneous influences on an individual company. According to Mr. Moul, the companies in the Water Group have the following characteristics: they are listed in the "Water Utility Industry" section (basic and expanded) of the Value Line Investment Survey; their stock is publicly traded; and they are not currently the target of a publicly-announced merger or acquisition.

Mr. Moul compared Indiana-American's financial data with that from the Water Group. Mr. Moul stated that the Company has a higher degree of capital intensity than the Water Group, it has somewhat more financial risk, its equity returns display more variability, its returns were lower, and its creditor protection (i.e., interest coverages) was weaker. He further stated that the Company has very substantial construction requirements for the future. Based on his analysis, Mr. Moul concluded that the Water Group provides a conservative basis for measuring the Company's cost of equity.

Mr. Moul relied on four measures in analyzing the Company's cost of equity: the Discounted Cash Flow ("DCF") model, the risk premium model, the Capital Asset Pricing Model ("CAPM"), and the Comparable Earnings approach.

(a) **DCF Analysis.** Mr. Moul stated that the DCF methodology requires the use of an expected dividend yield to establish the investor-required cost of equity. For purposes of his analysis, Mr. Moul used the six-month average dividend yield of 3.30% for the Water Group, which he stated reflects current capital costs while avoiding spot yields. Mr. Moul then adjusted the six-month average dividend yield to reflect growth in dividends during the initial investment period and quarterly dividend payments to arrive at an adjusted dividend yield of 3.42% for the Water Group.

As to the appropriate growth rate, Mr. Moul opined that all relevant growth rate indicators using a variety of techniques must be evaluated when formulating a judgment of investor expected growth. He stated that negative growth rates reflected in historical data provide no reliable guide to gauge investor expected growth for the future and thus should not be given any weight when formulating a composite growth rate expectation. Mr. Moul testified that

although ideally historical and projected earnings per share and dividends per share growth indicators would be used to provide an assessment of investor growth expectations for a firm, the circumstances of the Water Group mandate that greater emphasis be placed on projected earnings per share growth. He opined that projections of future earnings growth provide the principal focus of investor expectations and represent a reasonable assessment of investor expectations.

Mr. Moul provided projected earnings per share growth rates taken from analysts' forecasts compiled by I/B/E/S/First Call, Zacks, Morningstar, and Value Line. He testified that a five-year investment horizon associated with the analysts' forecasts is consistent with the DCF model. He testified that earnings per share growth provides the principal focus of investor expectations and is consistent with the recommendations of Professor Myron Gordon, the foremost proponent of the DCF model in rate cases. Mr. Moul indicated that the forecasts of earnings per share growth provide a range of growth rates from 6.63% to 9.62%. He concluded that his use of an investor-expected growth rate of 7.00% is a conservative representation of the analysts' growth rate forecasts.

Mr. Moul made two adjustments to his DCF results, a leverage adjustment and a flotation cost adjustment. Mr. Moul stated that a leverage adjustment is necessary if book values are used to compute the capital structure ratios. He stated that if regulators rely on the results of the DCF, which are based on the market price of the stock of the companies analyzed, and use those results in computing the weighted average cost of capital with a book value capital structure, those results will not reflect the degree of financial risk associated with the book value capital structure. His leverage adjustment is computed with the return for an unleveraged company plus the additional return to reflect the risk associated with having senior debt and preferred stock in the capital. Based on his calculation, Mr. Moul concluded that the appropriate leverage adjustment for the Company was 1.02%.

Mr. Moul testified that a flotation cost adjustment is computed to recognize the cost of issuance when additional common equity is issued. This is to compensate for the underwriting discount and issuance expenses associated with the issuance of new common stock. Mr. Moul utilized a flotation cost adjustment of 0.23% in his DCF model, which, when combined with an adjusted dividend yield of 3.42%, a projected growth rate of 7.00%, and a leverage adjustment of 1.02%, results in a rate of return for the Company of 11.67%.

(b) **Risk Premium Analysis.** Mr. Moul stated that in a risk premium analysis, the cost of equity capital is determined by corporate bond yields plus a premium to account for the fact that common equity is exposed to greater investment risk than debt capital. Mr. Moul used a long-term public utility debt cost rate of 5.75%, which he opined was a reasonable estimate of the prospective yield on long-term A-rated public utility bonds. Mr. Moul stated that his long-term cost rate of 5.75% is supported by the Moody's Index and the Blue Chip forecasts. He noted that the historical yields for A-rated public utility debt during the twelve months ended February 2011 have ranged from 5.01% to 5.84%.

Mr. Moul determined the prospective yield on A-rated public utility debt by using the Blue Chip Financial Forecasts along with the spread in the historical yields noted above. He testified that the Blue Chip is a reliable authority and contains consensus forecasts of a variety of

interest rates compiled from a panel of banking, brokerage, and investment advisory services. Because Blue Chip stopped publishing forecasts of yields on A-rated public utility bonds in early 1999, he combined the forecast yields on long-term Treasury bonds published on March 1, 2011, and a yield spread of 1.00%, which he opined was a reasonable spread for the yield on A-rated public utility bonds over Treasury bonds. Mr. Moul also provided Blue Chip's long-term forecasts of interest rates, which he stated further supported the use of a 5.75% yield.

Mr. Moul stated that he calculated the equity risk premium by comparing the market returns on utility stocks and the market returns on utility bonds. He used the S&P Public Utility Index for the purpose of measuring the market returns for utility stocks, which he stated is reflective of the risk associated with regulated utilities and reduces the role of judgment in establishing the risk premium for public utilities. To develop an appropriate risk premium, Mr. Moul averaged the results for the S&P Public Utilities by averaging the midpoint of the range shown by the geometric mean and median and the arithmetic mean. He explained that this procedure was employed to provide a comprehensive way of measuring the central tendency of the historical returns.

Based on this analysis Mr. Moul determined that a reasonable risk premium for the S&P Public Utilities in this case is 6.23%. Mr. Moul stated that differences in risk characteristics must be taken into account when applying the results for the S&P Public Utilities to the Water Group including size, market ratios, common equity ratio, return on book equity, operating ratios, coverage, quality of earnings, internally generated funds, and betas. Mr. Moul opined that these differences indicate that 5.50% represents a reasonable common equity risk premium in this case and is reflective of the lower risk of the Water Group compared to the S&P Public Utilities. Using this risk premium together with the prospective yield for long-term public utility debt and his flotation adjustment, Mr. Moul's risk premium approach provided a cost of equity for Petitioner of 11.48%.

(c) **CAPM Analysis.** Mr. Moul stated that three components are necessary to compute the cost of equity in a CAPM analysis: a risk-free rate of return; the beta measure of systematic risk; and the market risk premium. For the beta, Mr. Moul initially considered the Value Line betas. However, because the betas must be reflective of the financial risk associated with the rate setting capital structure that is measured at book value, Mr. Moul testified that a leverage adjustment similar to that utilized on the DCF model would be necessary. He used the Hamada formula to un-leverage and re-leverage the Value Line betas for the common equity ratios using book values. Mr. Moul calculated a leveraged beta of 0.89 for the Water Group associated with book value capital structure.

For the risk-free rate, Mr. Moul employed the yields on 20-year Treasury bonds using historical data. For forecasts, Mr. Moul used the yields on 30-year Treasury bonds that are published by Blue Chip. Mr. Moul summarized the various yields and determined that a 4.75% risk-free rate of return would be appropriate for CAPM purposes, as it considers not only the Blue Chip forecasts but also the recent trend in the yields on long-term Treasury bonds.

Mr. Moul derived his market premium from the SBBI Classic Yearbook and the Value Line and S&P 500 returns. For the historically based market premium he used the arithmetic mean. Mr. Moul acknowledged that the Commission has expressed its preference for

considering both the arithmetic mean and the geometric mean and stated that if that approach is to be taken, much more weight should be placed on the arithmetic mean because it is the correct measure in the single-period model specification of the CAPM. Mr. Moul indicated that the market premium as taken from these sources is 6.86%.

Mr. Moul testified that an adjustment must be made to the CAPM result relating to the size of the company or portfolio for which the calculation is performed. Mr. Moul explained that as the size of a firm decreases, its risk and, hence, its required return increases. He stated that the Water Group has an average market equity capitalization of \$1,423 million, which would make it a low-cap portfolio. While Mr. Moul noted that this low-cap market capitalization would indicate a size premium of 1.98%, he used a more conservative size adjustment of 1.20%, which represents the mid-cap adjustment.

Based on a 4.75% risk-free rate of return, the leverage adjusted beta of 0.89 for the Water Group, the 6.86% market premium, the 1.20% size adjustment and the flotation cost adjustment developed previously, the cost of equity resulting from Mr. Moul's CAPM analysis is 12.29%.

(d) **Comparable Earnings Analysis.** Mr. Moul testified that he performed this analysis because regulation is a substitute for competitively driven prices and the returns realized by non-regulated firms with comparable risks provide useful insight into a fair rate of return. He selected non-regulated companies from the Value Line Investment Survey that have six categories of comparability designed to reflect the risk of the Water Group. Mr. Moul stated that Value Line provides a comprehensive basis for evaluating the risks of the comparable firms. He used both historical realized returns and forecasted returns covering a ten-year period (5 historical years and 5 projected years) in order to cover conditions over an entire business cycle.

Unlike with the DCF or CAPM approaches, Mr. Moul indicated that a leverage adjustment was not necessary when using the Comparable Earnings method because it can be applied directly to the book value capitalization, avoiding the potential misspecification with the other models. Mr. Moul stated that the results from the Comparable Earnings approach suggest a reasonable cost of equity for Petitioner of 12.40%, representing the average of the historical and forecast median rates of return for the comparable earnings group.

Based on his application of a variety of methods and models, Mr. Moul opined that the cost of common equity for the Company in this case is 11.50%. He further opined that it is essential that the Commission employ a variety of techniques to measure the Company's cost of equity because of the limitations/infirmities that are inherent in each method.

(2) **OUC's Position.** Mr. Edward R. Kaufman, CRRA, a Senior Analyst with the OUC, presented testimony regarding Petitioner's cost of equity. Mr. Kaufman used both DCF and CAPM analyses to estimate Petitioner's cost of equity at 8.6%. He did not conduct risk premium or Comparable Earnings analyses. Mr. Kaufman's DCF models produced a range of estimates from 8.40% to 9.45%, and his CAPM analysis produced a range of estimates from 7.71% to 7.95%. Mr. Kaufman stated that a cost of equity of 8.6% results in a weighted cost of capital of 6.47%, as shown by Ms. Stull. Mr. Kaufman explained that the difference

between his and Mr. Moul's cost of equity estimates is the result of inputs to the various models, adjustments that Mr. Moul made to his models, and the weight given to each of the models.

Mr. Kaufman testified that Petitioner's cost of debt since its last rate case has declined by almost 50 basis points from 6.96% to 6.52%. He stated that the decrease in Petitioner's cost of equity since its last rate case is illustrated by the decline in the beta of his water company proxy group from 0.793 to 0.722. Mr. Kaufman testified that inflation influences interest rates and interest rates influence the cost of equity. He stated that for the past several years interest rates have been at historically low levels, and interest rates have further declined during the past few months. Mr. Kaufman provided several examples that showed that relevant interest rates had declined. For example, he testified 30-year US Treasury yields declined from 4.19% to 3.37%. Mr. Kaufman also noted that 10-year US Treasury bonds hit a record low of 1.91% on September 9, 2011. He explained that lower interest rates translate directly into a lower cost of equity and long-term capital costs are as low or are lower today than they have been during most of the last 50 years.

Mr. Kaufman explained that he generally accepted and used Mr. Moul's Water Group, but he also included Artesian Resources in his proxy group. On cross examination Mr. Moul agreed Artesian Resources meets his screening criteria but was not covered by Value Line at the time Mr. Moul filed his testimony. Mr. Kaufman divided the proxy group into two categories for purposes of his DCF model: (1) the "Value Line proxy group" consisting of four out of the five water companies covered by Value Line's Standard Universe; and (2) the "AUS proxy group" comprising the same eight companies used in Mr. Moul's analysis, plus Artesian Resources. Mr. Kaufman stated that his AUS proxy group did not have the same level of data as for his Value Line proxy group, and therefore, he gave it less weight. He stated that it was not necessary to divide the companies into two proxy groups for purposes of his CAPM analysis because he had the same level of detail (beta) for all nine companies.

Mr. Kaufman used a traditional single stage DCF model for his Value Line proxy group, and used both historical and forecasted growth rates of earnings per share, dividends per share, and book value per share from Value Line. He estimated a growth rate of 5.21% for his Value Line proxy group. For his AUS proxy group, Mr. Kaufman used a single stage DCF model, using forecasted growth rates of earnings per share from Value Line, Yahoo.com (which relies on I/B/E/S Thomson Financial), and Morningstar to determine an estimated growth rate of 5.96%.

In both single-stage DCF analyses Mr. Kaufman eliminated zero and negative growth rates, consistent with the 1996 Rate Order, although he did not believe that investors completely ignore these growth rates. He did not eliminate low positive growth rates as he explained that low growth rates are not ignored by investors. Mr. Kaufman explained that he also did not eliminate high positive growth rates. He stated that his growth rate of 5.21% is supported by a Value Line chart titled "A Long-term Perspective," which provides average growth rates in earnings per share, dividends per share, and book value per share.

Mr. Kaufman asserted that short- to intermediate-term forecasts can lead to unreasonably high estimated growth rates in a DCF analysis, and should not be mechanically incorporated into a DCF analysis. To support his claim, Mr. Kaufman cited a 2003 article published in the

National Regulatory Research Journal of Applied Regulation, which stated that no utility can sustain a growth rate over the long run that exceeds the growth rate of the economy. Mr. Kaufman further cited a 2003 Wall Street Journal article as indicating that analysts' forecasts are potentially biased upwards due to possible financial incentives. Along with the Wall Street Journal article Mr. Kaufman also cited to two articles by McKinsey Quarterly to further support his opinion that analyst forecasts were bullish. Mr. Kaufman concluded that both the potential for analyst bias and the intermediate term nature of analyst forecasts of earnings per share may make these estimates potentially unreliable. Mr. Kaufman asserted that, even assuming no analyst bias, unsustainable growth rates should be adjusted or given reduced weight.

Mr. Kaufman stated that a two-stage DCF model allows one to give appropriate weight to short-term or intermediate-term forecasts in earnings per share to estimate the cost of equity. Mr. Kaufman then described the mechanics of the 2-stage DCF model. He explained that it is reasonable to use a forecasted growth rate of the U.S. economy as a long-term sustainable growth. To determine this growth rate, Mr. Kaufman used a forecasted growth rate presented by Mr. Moul of 4.75%. He also consulted a number of sources that provide forecasted real growth and forecasted inflation to support his use of Mr. Moul's 4.75% forecasted growth in the U.S. economy or GDP.

Mr. Kaufman next explained the mechanics of his two-stage DCF analysis. He indicated that he used inputs from Mr. Moul's single stage DCF analysis to produce an estimated cost of equity based on a two-stage DCF analysis. He used a dividend yield of 3.42%, a near term dividend growth rate of 7.0%, and the long-term EPS growth rate of 4.75% to produce an estimated cost of equity of 8.71%. Mr. Kaufman explained that he used his 2-stage DCF model as a check to the results of his single stage DCF analysis, and that he gave significantly more weight to his single stage DCF analysis for his Value Line proxy group because it was the most consistent with prior Commission decisions.

Mr. Kaufman then presented the results of his CAPM analysis. He indicated that the CAPM is typically more controversial and less reliable than the DCF model, and that different applications of CAPM may cause vastly different cost of equity estimates. He testified that he believes a geometric mean is a better approach to determine the risk premium than an arithmetic mean, but stated that his CAPM analysis considers both geometric and arithmetic mean risk premiums. To support his position, Mr. Kaufman cited to the 1982 Ibbotson Yearbook. Mr. Kaufman noted that more recent versions of the Ibbotson Yearbook advocate the use of only the arithmetic mean but provide no explanation for this change. He also cited to several articles and texts that recommended using the geometric mean rather than the arithmetic mean. Mr. Kaufman explained that the Commission has consistently given weight to both arithmetic mean and geometric mean risk premiums, for example in Petitioner's most recent rate case, Cause No. 43680.

Mr. Kaufman stated that he also developed a forecasted risk premium in addition to his risk premium based on historical data because the expected risk premium is below the historical averages. Based on his review of a number of articles that provided a range of forecasted market risk premiums from a low of 1.5% to a high of 5.25%, Mr. Kaufman stated that his CAPM analysis used a forecasted risk premium of 5.25%. He noted, however, that the historical risk premium is only 5 basis points lower (5.20%) than his forecasted risk premium of 5.25%. Mr.

Kaufman testified that the cost of equity based on his CAPM analysis using a historical risk premium ranged from 7.71% to 7.91%, and the cost of equity based on his CAPM analysis using a forecasted risk premium ranged from 7.75% to 7.95%.

Mr. Kaufman's cost of equity models produced a range of equity estimates of 7.71% to 9.45% with a midpoint of 8.58%. Mr. Kaufman explained that giving weight to models consistent with past Commission orders produced a range of equity estimates of 7.71% to 8.44% with a midpoint of 8.08%. Mr. Kaufman recommended a cost of equity above the high end of his range. Based on his DCF and CAPM analyses, Mr. Kaufman recommended a cost of equity of 8.60%. He explained that there was no need to adjust the results of his proxy group's cost of equity to make it applicable to Indiana-American as he believed Indiana-American has a similar business and financial risk to the companies in the proxy group. Mr. Kaufman discussed industry sources supporting a view that his proposed cost of equity of 8.6% is reasonable in today's markets. Mr. Kaufman indicated the Duke CFO survey, the Schwab Center for Financial Research, an article from Portfolio Solutions and J.P. Morgan, all predicted long run stock returns below 8.6%. Mr. Kaufman noted that Petitioner's proposed annual expense for its Pension and OPEBs assumes a long-term return on large capitalization equities of 8.85%. Mr. Kaufman argues that if an 8.85% forecasted return on large capitalization equities is appropriate to determine Petitioner's Pension/OPEB expenses, then it is also appropriate to help estimate its cost of equity, especially for models that rely on an estimate of market returns.

Mr. Kaufman next expressed his concerns regarding Mr. Moul's cost of equity analysis. First Mr. Kaufman briefly discussed why, despite Mr. Moul's comments, the business risk of the water industry remains low. Mr. Kaufman's testimony included Mr. Moul's response to OUCC Discovery Request 03-001 that showed each water company in Mr. Moul's proxy group (rated by S&P) had a business risk of "Excellent." "Excellent" is S&P's highest – i.e. least risky – rating.

Mr. Kaufman commented on Mr. Moul's DCF model. He explained that Mr. Moul's reliance on intermediate term forecasts for earnings per share results in a growth rate that is unrealistically high. Mr. Kaufman explained that Mr. Moul's reliance on forecasted growth rates for his DCF analysis was improper, as these estimates are not long-term (perpetual) estimates and may overstate cost of equity. These estimates are made typically for only three to five years. Three to five year estimates are likely to be optimistic and overstate long-term growth, and they do not necessarily represent a reasonable long-term growth estimate. He stated that in a single-stage DCF model, it is necessary to use a growth rate that is sustainable over the long run as the equation used in the DCF model assumes an infinite time frame.

Mr. Kaufman then explained how using Mr. Moul's inputs in a 2-stage DCF analysis would reduce the results of a DCF analysis by 170 basis points. Mr. Kaufman also disputed Mr. Moul's use of the FERC language stating that the 2-stage DCF model should only be used if the forecasted growth in EPS is at least 2 to 3 times higher than forecasted GDP. Mr. Kaufman explained that in a setting where parties are disputing adjustments as small as 23 basis points (Mr. Moul's flotation cost adjustment), he did not believe we needed to wait until an intermediate term forecasted growth rate exceeded the long-term growth rate by 2-3 times to justify using multiple growth rates.

Mr. Kaufman next discussed his concerns with Mr. Moul's leverage adjustment. He disagreed that the difference between market and book value creates a need to adjust the results of a DCF analysis and therefore asserted that Mr. Moul's leverage adjustment is unnecessary. He pointed out that Mr. Moul provided no numerical analysis to support his argument that a leverage adjustment is necessary when a utility's market-to-book ratio is different from 1.0 and most jurisdictions do not use Mr. Moul's adjustment. Mr. Kaufman testified that the leverage adjustment proposed by Mr. Moul has the effect of rewarding utilities when market-to-book ratios are high and penalizing utilities when market-to-book ratios are low. Mr. Kaufman asserted that if Mr. Moul had applied his leverage adjustment directly to American Water in Petitioner's last rate case, it would likely have led to a negative leverage adjustment.

Mr. Kaufman next criticized Mr. Moul's CAPM analysis, which Mr. Kaufman explained contained an improper leverage adjustment, overstated the risk premium, and included unnecessary adjustments for size and for flotation costs. Mr. Kaufman disagreed with Mr. Moul's sole use of an arithmetic mean calculation and stated a historical risk premium should be based on both geometric and arithmetic mean calculations. Mr. Kaufman explained that ignoring the geometric mean overstates expected returns. Mr. Kaufman pointed out that the SEC requires mutual funds to report historical earned returns using a geometric mean calculation and that the Commission has consistently given weight to both the geometric and arithmetic mean. Mr. Kaufman also challenged Mr. Moul's second historical risk premium, which improperly used bond income returns instead of bond total returns. Mr. Kaufman explained that investors who buy long-term bonds earn total returns, not income returns. Mr. Kaufman cited the 2005 Rate Order to support his criticism of Mr. Moul's reliance on income returns to estimate the market risk premium.

Mr. Kaufman disagreed with Mr. Moul's 7.37% forecasted risk premium because Mr. Moul's source data was overly optimistic. Mr. Kaufman stated that Mr. Moul's forecasted market risk premiums resulted from market forecasts of 12.47% and 11.76%, both of which dramatically exceed the historical market return. In particular, Mr. Kaufman explained the inherent unreliability of the Value Line Price Appreciation Potential data and the flaws in using First Call's 9.85% 5-year growth estimate as a substitute for a sustainable, long-term growth rate.

Mr. Kaufman next took issue with Mr. Moul's size adjustment, stating that it is not appropriate to directly apply the Ibbotson Yearbook's equity size premium adjustment to regulated water utilities. He stated that regulation decreases the risks faced by Petitioner and the companies in Mr. Moul's Water Group and those companies do not face the same bankruptcy risks that other small companies may face. He also stated that the Commission's Order in Cause No. 40398 determined that the Ibbotson Yearbook's small cap adjustment cannot be directly applied to utilities. Mr. Kaufman also cited articles by Business Valuation Alert and by Annie Wong, supporting his conclusions. For the same reasons he disagreed with the leverage adjustment proposed in Mr. Moul's DCF analysis, Mr. Kaufman disagreed with the leverage adjustment that Mr. Moul made to his CAPM analysis. He noted that Mr. Moul did not cite any jurisdictions that accepted his leverage adjustment for a CAPM analysis.

Mr. Kaufman testified that Mr. Moul's risk premium model overstates the risk premium, uses a forecasted interest rate that exceeds the current interest rate and includes an unnecessary adjustment for flotation costs. Mr. Kaufman explained that Mr. Moul's use of median returns,

which exceed both the arithmetic and geometric mean returns, further reduced the reliability of Mr. Moul's model. Mr. Kaufman stated that this approach inflates the expected return for the S&P Utility Index and deflates the expected return for Public Utility Bonds. Mr. Kaufman agreed with the 2010 Rate Order and disagreed with Mr. Moul's argument that there was no need to update his risk premium analysis for 2008, 2009, and 2010 data in this case. Mr. Kaufman testified that if Mr. Moul's risk premium model was updated to include 2008, 2009, and 2010 data, it results in an unadjusted risk premium of only 4.02%. Mr. Kaufman further testified that if Mr. Moul's risk premium model is adjusted to give equal weight to arithmetic and geometric means, and no weight to median returns, it would result in a premium of 3.25%.

Mr. Kaufman did not agree with Mr. Moul's use of forecasted interest rates in his CAPM and risk premium analyses. He explained that a purchaser of long-term debt is effectively making a forecast, and therefore the purchase price produces a yield that the investor is willing to accept over the life of the debt. He further explained that a forecast of increasing interest rates is also a forecast of declining bond prices, and that if a potential purchaser expected the price to decrease, that would be reflected in the current purchase price. Mr. Kaufman surmised that a current yield is already a forward-looking yield over the investment horizon. Mr. Kaufman explained that if a risk premium of 3.25% was added to the current yield on "A" utility bonds of 4.55%, it would produce an estimated cost of equity of 7.8%. Mr. Kaufman testified Mr. Moul's proposed cost of equity for his risk premium model of 11.48% exceeds the average actual return earned for the S&P Public Utility Index from 1928-2010 of 8.36% and that given today's historically low interest rates it is counterintuitive for this model to produce an estimated cost of equity well in excess of the historical returns.

Mr. Kaufman expressed concerns over Mr. Moul's Comparable Earnings approach. He explained that Mr. Moul's analysis does not exclude outliers, nor did Mr. Moul screen his proxy group for dividends or percentage of long-term debt. Mr. Kaufman further explained that a company with little or no long-term debt or that does not pay significant dividends is not comparable to either Indiana-American or Mr. Moul's Water Group. Mr. Kaufman expressed concern that historical returns do not react to changes in market conditions, and so the comparable earnings methodology can produce increasing returns during periods of declining capital costs. He noted that the Commission disregarded the results of Mr. Moul's Comparable Earnings analysis in the 2010 Rate Order.

As to Mr. Moul's flotation cost adjustment, Mr. Kaufman asserted that Petitioner has not justified the need to recover flotation costs in this case. He noted that the Commission has typically allowed utilities to recover measurable and reasonable flotation costs when the utility has recently incurred or expects to incur flotation costs in the near future. Mr. Kaufman stated that because Mr. Moul is proposing a generic flotation cost adjustment not based on actual costs incurred by Indiana-American or by American Water on behalf of Indiana-American, a flotation cost adjustment should not be included in Indiana-American's authorized cost of equity.

Mr. Kaufman explained that his proposed cost of equity is reasonable. He testified that Petitioner's actuarial study assumes the S&P 500 will earn a return of 8.85%, the average historical return of the S&P Public Utility Index from 1928-2010 is only 8.36% the Third Quarter 2011 Duke Survey of CFO's forecasts a 10-year mean for the S&P 500 of 6.5% and the Schwab Center for Financial Research forecasted a long-term (20 year) annual rate of return for

large-cap stocks of 7.9%. Mr. Kaufman discarded the lowest result and calculated that the three remaining diverse sources produced an average return of 8.37%. Mr. Kaufman noted that because Petitioner is less risky than the market, his proposed return of 8.6%, which exceeds the average return of 8.37%, is reasonable and should be approved by the Commission.

(3) **Industrial Group's Position.** Mr. Michael Gorman, a consultant and Managing Principal with the firm of Brubaker & Associates, Inc., sponsored testimony recommending a 9.40% ROE. Mr. Gorman opined that based on the data he reviewed and the analysis he performed, Indiana-American's cost of common equity is no higher than it was in the Company's last rate case, and that his 9.40% return is reasonable. Mr. Gorman also noted that current market conditions, in which utility bond yields are 90-100 basis points lower than they were prior to the 2010 Rate Order, suggests that the Company's current market cost of equity is well below the 10.0% cost of equity approved in that Order.

Mr. Gorman stated that Indiana-American's own analysis supported a lower cost of common equity than in the Company's prior rate case. In that case, Mr. Moul recommended an ROE of 12.0%, but, in this case, is only recommending an ROE of 11.50%. Mr. Gorman compared that 50 basis point reduction to his own recommendation, which is 50 basis points lower than the 9.9% return he proposed in the Company's last rate case. He explained that these comparable reductions indicate that Indiana-American's cost of common equity is lower today than at the time of the last rate case.

Mr. Gorman utilized five models to estimate Indiana-American's cost of common equity: (1) a constant growth DCF model using analyst growth data; (2) a Sustainable Growth DCF model; (3) a Multi-Stage Growth DCF model; (4) a risk premium analysis; and (5) a CAPM.

Mr. Gorman testified that he relied on two proxy groups, Mr. Moul's Water Group and a proxy group that consisted of ten gas utilities, to estimate Indiana-American's current cost of capital. He explained that it was necessary to rely on the gas proxy group in addition to the water proxy group for several reasons. First, the gas proxy group's securities were more widely followed than water utility stocks, and provide a more robust estimate of the market cost of equity. Second, market participants consider the investment risk of water and gas utilities to be comparable as is evidenced by the practice of S&P credit reports, which typically combine the two types of utilities in reports to investors. Third, the asset mix, capitalization, and operations of the two types of utilities are very similar because they are dependent on large main investment and operations, infrastructure replacement and upgrades, and compliance with local, state, and federal regulations. For these reasons, Mr. Gorman opined that reliance on the two proxy groups provided a better risk proxy of Indiana-American than the Water Group alone. Mr. Gorman also opined that Indiana-American's financial risk is reasonably comparable to both the water and gas proxy groups.

Mr. Gorman testified that he measured the Company's investment risk by relying on the bond rating of American Water and its financing subsidiary, American Water Works Capital Corporation ("AWC"), as a proxy for Indiana-American's bond rating. He also relied on Indiana-American's stand-alone capital structure to measure the investment risk of the Company relative to that of the two proxy groups.

Mr. Gorman explained that it is appropriate to use American Water and AWC's bond ratings as a proxy because AWC obtains its credit standing through affiliation with Indiana-American and American Water's other operating affiliates. Mr. Gorman further explained that American Water is structured to mitigate operating risks and financial risks by consolidating utility operations within its holding company structure. Mr. Gorman opined this reduced Indiana-American's financial and operational risks by eliminating small company risk and by opening access to markets for bond issuances that likely reduce the cost of borrowing. Mr. Gorman also stated that because ratepayers pay for the risk reductions through shared services fees, they should receive the benefits of the corporate structure through reduced capital costs.

In his constant growth DCF model, Mr. Gorman relied on the average of the weekly high and low stock prices of the proxy groups over a 13-week period ending September 23, 2011. Mr. Gorman opined that in his judgment, the use of the 13-week average stock price is a reasonable balance between the need to reflect current market expectations and the need to collect sufficient data to smooth out aberrant market movements. Mr. Gorman stated that he relied on two sources of growth for his constant growth DCF model. In his first constant growth DCF analysis, Mr. Gorman relied on a consensus of professional security analyst's earnings growth estimates as a proxy for investor consensus dividend growth rate expectations. Specifically, Mr. Gorman averaged growth rates estimates from Zacks, SNL Financial, and Reuters to calculate average growth rates of 7.25% and 4.54% for the water and gas proxy groups, respectively. Using these growth rates, Mr. Gorman calculated average constant growth DCF rates of 10.77% and 8.43% for the water and gas proxy groups, respectively. Mr. Gorman concluded that the constant growth DCF return for the water proxy group is not reasonable and represents an inflated ROE for Indiana-American at this time. Mr. Gorman opined that the 7.25% growth rate is far too high to be a reasonable or reliable estimate of a long-term sustainable growth rate, as required in the constant growth model. Mr. Gorman testified that the 7.25% growth rate exceeds the projected growth rate of GDP. Mr. Gorman stated that the consensus of published economists is that GDP will grow at a rate of no more than 4.9% over the next five to ten years. Mr. Gorman stated that GDP growth projection represents a high-end sustainable growth rate for a utility because utilities cannot indefinitely sustain a growth rate greater than that of the overall economy. Mr. Gorman concluded that the constant growth DCF model relying on consensus analysts' growth rate estimates for the water proxy group does not produce a reasonable estimate of Indiana-American's cost of equity. Mr. Gorman also stated that the constant growth DCF return of the gas proxy group is slightly below a reasonable long-term sustainable growth estimate.

Mr. Gorman next discussed his sustainable growth DCF model. Mr. Gorman indicated that in this DCF study he used the internal growth rate methodology, which is tied to the percentage of earnings retained in the company. He testified that by using the internal growth rate model the sustainable growth rates for the Water Group were in the range of 6.51% (average) and 6.81% (median); and the sustainable growth rates for the gas proxy group were in the range of 5.98% (average) and 5.59% (median). Based on these sustainable growth rates Mr. Gorman developed an estimated average return of 9.85% for the Water Group and 9.92% for the gas proxy group.

Mr. Gorman testified a limitation of the constant growth DCF model is that it cannot reflect the rational expectation that a period of high and/or low short-term growth can be followed by a change in growth to a rate that is more reflective of a long-term sustainable growth

level. For that reason, he performed a multi-stage growth DCF analysis that reflects three growth periods: (1) a short-term growth period, which consists of the first five years; (2) a transition period, which consists of years six through ten; and (3) a long-term growth period starting in year 11 through perpetuity. For the short-term growth period, Mr. Gorman relied on the consensus analysts' growth projections used in his constant growth DCF model. For the transition period, Mr. Gorman reduced or increased the growth rates by an equal factor to reflect the difference between the analysts' growth rates and the GDP growth rate. For the long-term growth period, Mr. Gorman assumed the growth of each company in the proxy group would converge to the maximum sustainable growth rate for a utility company, or the consensus analysts' projected growth rate for GDP of 4.9% starting in year 11. The 4.9% projected GDP growth rate used by Mr. Gorman reflects the midpoint of consensus GDP growth rate projections published in the latest issue of *Blue Chip Economic Indicators*, which range from 5.1% to 4.7% over the next 5 and 10 years, respectively.

Mr. Gorman testified that his average multi-stage growth DCF ROEs were 8.96% for the Water Group and 8.71% for the gas proxy group. Based on the results of all three DCF models, Mr. Gorman found a reasonable range for the DCF returns to be 9.90%, rounded from 9.87%, to 9.00%, rounded from 9.02%, with a midpoint estimate of 9.50% rounded from 9.45%. Mr. Gorman opined that this midpoint is conservatively high because it gives some weight to the unreasonably high results derived for the water proxy group in the constant growth rate DCF model using analysts' growth rates.

Mr. Gorman stated that his risk premium model is based on the principle that investors require a higher return to assume greater risk. Mr. Gorman testified that his model is based on two estimates of equity risk premium. First, he estimated the difference between the required return on utility common equity investments and Treasury bonds with the difference being the risk premium. Mr. Gorman testified that the common equity required returns he used were based on regulatory commission authorized returns for gas utility companies. The second risk premium method utilized by Mr. Gorman is based on the difference between regulatory commission-authorized returns on common equity and contemporary "A" rated utility bond yields.

In both estimates, Mr. Gorman used the time period of 1986 through the second quarter of 2011, which he selected because during that time, public utility stocks consistently traded at a premium to book value. Mr. Gorman stated that the time period was selected to draw accurate results concerning contemporary market conditions. Mr. Gorman stated that reliance on a relatively long period of time where stock valuations reflect premium to book value is an indication that the authorized ROEs and the corresponding risk premiums supported investor expectations and provided utilities access to equity markets under reasonable terms. He further stated that the time period selected is long enough to smooth out market movements that might distort equity risk premiums. Mr. Gorman testified that the period he used is a generally accepted period to develop a risk premium analysis using "expectational" data and, therefore, does not require consideration of very long historical time periods.

Mr. Gorman testified that based on his analysis, the average indicated equity risk premium over Treasury bond yields has been 5.09% with three-quarters of the results falling in a range of 4.15% to 5.93%. Mr. Gorman also testified that the average indicated equity risk

premium over contemporary Moody's utility bond yields was 3.67% over the period 1986 through the second quarter of 2011, with the results primarily falling in the range of 3.04% to 4.43%.

Mr. Gorman stated that the equity risk premium should reflect the relative market perception of risk in the utility industry today. To gauge that risk, he reviewed utility bond yield spreads for "A" rated and "Baa" rated utility bonds over Treasury bond yields for 2008, 2009, and 2010. Mr. Gorman testified that in 2010 the yield spreads had declined to 1.21% and 1.71% for "A" and "Baa" rate utility bonds, respectively. Mr. Gorman stated that these spreads over Treasury bond yields are now lower than the 30-year average spreads of 1.59% and 1.99%, respectively. Mr. Gorman also compared the 13-week average "A" rated utility bond yield of 4.82% with the current Treasury bond yield of 3.79%, and found the yield spread of 1.03% to be lower than the 1.59% 30-year average yield for "A" rated utility bonds. Mr. Gorman also compared the 13-week average "Baa" rated utility bond yield of 5.34% with the current Treasury bond yield, and found the yield spread of 1.55% to be lower than the 1.99% 30-year average yield for "Baa" rated utility bonds. Mr. Gorman opined that these reduced yield spreads are clear evidence that the market considers the utility industry to be a relatively low risk investment and that utilities continue to have strong access to capital.

In performing his risk premium analysis, Mr. Gorman added a projected long-term Treasury bond yield of 4.2% to his estimated risk premium over Treasury yields. Using the projected 30-year bond yield of 4.2% and the Treasury bond risk premium of 4.15% to 5.93%, Mr. Gorman produced an estimated common equity return in the range of 8.35% to 10.13%, with a midpoint of 9.24%. Using his utility equity risk premium of 3.04% to 4.43% and the 13-week average yield of 5.34% on "Baa" rated utility bonds, Mr. Gorman produced an estimated cost of equity in the range of 8.38% to 9.77%, with a midpoint of 9.08%. Mr. Gorman therefore testified that his risk premium analyses produce an estimated cost of equity in the range of 9.08% to 9.24%, with a midpoint estimate of 9.16%, rounded to 9.20%.

Mr. Gorman testified that a CAPM analysis is based on the theory that the market required rate of return for a security is equal to the risk free rate, plus a risk premium associated with the specific security, and explained that the risk associated with a specific security is expressed as "beta". To determine the risk free market rate, Mr. Gorman relied on the 4.2% projected 30-year Treasury bond yield he used in his risk premium analysis that was derived from Blue Chip Financial Forecasts projections. To determine the beta, he used the average Value Line beta estimates of 0.74 and 0.68 for the water and gas proxy groups, respectively. Mr. Gorman also relied on a historical market risk premium of 6.0%. He derived this historical risk premium using Morningstar data from 2006 through 2010, which estimated the arithmetic average of the achieved total return on the S&P 500 of 11.90% and the total return on long-term Treasury bonds of 5.9%. Mr. Gorman also produced a forward-looking risk premium estimate that he derived by estimating the expected return on the market (represented by the S&P 500) and subtracting the risk-free rate. Mr. Gorman calculated a forward-looking risk premium of 7.0%. Mr. Gorman stated that his average market risk premium of 6.5% is consistent with Morningstar's analysis, which produces a market risk premium in the range of 6.0% to 6.7%. Although Mr. Gorman disagreed with some assessments made by Morningstar, he used Morningstar's 6.7% risk premium conclusion to demonstrate the reasonableness of his own market risk premium estimates.

Using these inputs, Mr. Gorman's CAPM analysis produced estimated returns of 9.16% for the Water Group and 8.76% for the gas proxy group. Mr. Gorman gave greater weight to the high end of this range, first, because it was reasonably close to the results of his risk premium analysis and, second, because the beta for water utilities appears to be higher than that for the gas utility proxy group. Therefore, as a conservative estimate, Mr. Gorman opined that based on his CAPM study an ROE for Indiana-American in this proceeding would be 9.16%, rounded to 9.20%.

Based on all his cost of equity models, which ranged from 9.20% to 9.50%, Mr. Gorman recommended an overall ROE for Indiana-American of 9.40%, which is the mid-point of 9.35% rounded up. Mr. Gorman opined that with Indiana-American's proposed capital structure and his recommended ROE, Indiana-American's financial credit metrics are supportive of an investment grade bond rating.

Mr. Gorman next responded to Mr. Moul's recommended cost of common equity of 11.50%. He stated that Mr. Moul's use of adders in his various models is unreasonable and inflates his estimated return for Indiana-American. Mr. Gorman further testified that Mr. Moul's proposed ROE is excessive, and that with reasonable and appropriate adjustments to Mr. Moul's own analyses, his studies would support an ROE of 9.26%.

With respect to Mr. Moul's DCF analysis, Mr. Gorman stated that at a minimum Mr. Moul's proposed flotation cost and leverage adjustments should be rejected. Mr. Gorman opined that even with these adjustments removed, however, Mr. Moul's DCF result is inflated because it relies on a growth rate estimate of 7.00%, which is too high to be a reasonable estimate of long-term sustainable growth, and because Mr. Moul's yield adjustment to reflect quarterly compounding of dividend payments does not accurately estimate a utility's cost of capital.

Mr. Gorman stated that Mr. Moul's leverage adjustment is erroneous for several reasons. Mr. Gorman testified that Mr. Moul's contention that the adjustment should be made for differentials in financial risk, depending on a review of either book value or market value capital structure, is erroneous. Mr. Gorman explained that Mr. Moul's adjustment is flawed because he does not compare Indiana-American's market value capital structure to the market value capital structure of the Water Group, and that, therefore, there is no basis for Mr. Moul to conclude that Indiana-American's leverage is greater than the proxy companies based on market value capitalization. Mr. Gorman concluded that Mr. Moul's proposed leverage risk adjustment is unfounded. Mr. Gorman also pointed out that Mr. Moul's own risk comparison of Indiana-American to the Water Group shows that the book value capital structure risk of each proxy group company is reasonably comparable to the book value capital structure risk of Indiana-American.

Mr. Gorman disagreed with Mr. Moul's flotation cost adjustment because it does not clearly identify and provide recovery of prudent and reasonable cost expense incurred by Indiana-American. Mr. Gorman stated that the flotation cost adjustment should be rejected because it is not based on Indiana-American's actual and verifiable flotation expenses, but rather on other publicly traded companies' flotation expenses. Mr. Gorman concluded that there is no means to verify the reasonableness of the proposed flotation adjustment, nor the appropriateness

of applying it to Indiana-American's rates, because Mr. Moul provided no evidence of the Company's actual flotation costs.

Mr. Gorman expressed concern with the growth estimate included in Mr. Moul's DCF estimate. He noted that Mr. Moul correctly places emphasis on the projected three- to five-year growth rates from I/B/E/S First Call, Zacks, Morningstar, and Value Line but stated that the 7.00% growth rate selected by Mr. Moul is unreasonable and substantially exceeds a rational outlook for a long-term sustainable growth rate for utility stock. Mr. Gorman emphasized that a constant growth rate DCF model, as used by Mr. Moul, requires a growth rate that can be sustained indefinitely. Mr. Gorman reiterated his belief that rational estimates of long-term sustainable growth rates cannot exceed GDP and stated that Mr. Moul's contrary belief is against the weight of academic, regulatory, and investment practitioner outlooks. Mr. Gorman argued that the 7.00% growth rate used by Mr. Moul, which exceeds the long-term projected GDP growth rate, cannot be sustained over the long-term. Mr. Gorman testified that a rational utility investor would not believe Mr. Moul's growth projections because they imply a utility can sustain growth rates that exceed the long-term growth of the economy in which it sells its services. Mr. Gorman stated that this is simply not rational.

Mr. Gorman rejected Mr. Moul's adjustment to the dividend yield to reflect quarterly compounding of dividends. Mr. Gorman explained it is not a cost to the utility and therefore compound return is not paid to the utility's investors. Mr. Gorman testified that only the utility's cost of common equity capital should be included in the authorized rate of return. He further stated that if the dividend reinvestment return is included in the authorized ROE, then investors will actually receive the dividend reinvestment twice, once through the ROE, and a second time when dividends are received and reinvested.

Mr. Gorman stated that his primary issue with Mr. Moul's risk premium analysis is his equity risk premium of 5.50%, which Mr. Gorman opined is arbitrary and has not been shown to be appropriate for Indiana-American. Mr. Gorman stated that Mr. Moul's projection is not based on an independent assessment or market participation projection. Rather, Mr. Moul's projection is based on estimated returns over various periods between the S&P Public Utility Index and utility bond yields, which led Mr. Moul to conclude that the S&P Public Utility Index equity risk premium over prevailing utility bond yields was 6.23%. He then reduced that figure to 5.50% to derive an equity return for the Water Group. Mr. Gorman stated that the failure to rely on observable and verifiable market factors to adjust the equity risk premium eliminates the usefulness of Mr. Moul's risk premium estimate. Mr. Gorman testified, however, that if an appropriate equity risk premium for Indiana-American were used, Mr. Moul's analysis would produce a risk premium return in the range of 8.79% to 10.18%, with a midpoint of 9.48%.

Mr. Gorman expressed concerns with Mr. Moul's CAPM analysis similar to Mr. Moul's DCF model. Mr. Gorman did not agree with Mr. Moul's leverage adjustment, flotation cost adjustment, or "small size" adjustment. Mr. Gorman also stated that Mr. Moul's market risk premium of 6.86% is excessive. Mr. Gorman explained that Mr. Moul's size adjustment and his leverage adjustment to the beta should be rejected for a variety of reasons. Mr. Gorman testified the leverage adjustment was unnecessary because projections of leveraged risk are based on book value, not market leverage value. Further, Mr. Gorman testified that the beta adjustment ignores systemic risk factors that distinguish Indiana-American's systemic risk from that of the

proxy group, and that Mr. Moul's application of the adjustment is erroneous. Mr. Gorman testified that Mr. Moul applies the leverage adjustment to the already adjusted Value Line beta, which makes Mr. Moul's further adjustment redundant and unreasonable.

Mr. Gorman also concluded that Mr. Moul's small size adjustment was flawed. Mr. Gorman stated that Mr. Moul's proposal relies on "mid-cap" deciles to adjust Indiana-American's ROE, but testified the Morningstar study used by Mr. Moul shows that companies in the mid-cap deciles have beta estimates of 1.13, which Mr. Gorman explained represented a significantly greater risk than the Water Group. Mr. Gorman testified the adjustment should, therefore, be rejected because it is not based on companies with comparable risk to Indiana-American.

With respect to Mr. Moul's market risk premium, Mr. Gorman testified that it was derived by averaging Mr. Moul's historical market risk premium with his prospective market risk premium of 7.37%. Mr. Gorman recommended rejecting Mr. Moul's prospective market risk premium because Mr. Moul did not provide any detail underlying his projected market return. Mr. Gorman updated Mr. Moul's CAPM analysis to remove the flawed adjustments and the prospective market risk premium and derived a CAPM return estimate of 9.45%.

Finally, Mr. Gorman responded to Mr. Moul's Comparable Earnings analysis. Mr. Gorman stated that Mr. Moul's analysis does not measure the appropriate return to use to ensure that Indiana-American is fairly compensated and that the ratepayers are not charged an excessive rate of return. Mr. Gorman also testified that Mr. Moul's analysis is not based on companies that have been shown to have risk comparable to that of Indiana-American, and that the book ROE cannot be considered a comparable "accounting" return appropriate to set Indiana-American's rates. Mr. Gorman noted that the companies used by Mr. Moul are non-regulated, and he opined that it is not reasonable to estimate an appropriate book ROE for Indiana-American from book ROEs for non-regulated companies in part because differences in regulatory accounting principles can produce higher book ROEs for regulated companies compared to non-regulated companies. In light of the problems with Mr. Moul's comparable earnings model, Mr. Gorman recommended that it should be disregarded.

(4) **Schererville's Position.** Town of Schererville witness, Mr. Theodore J. Sommer testified that Petitioner's ROE should be 9.75%. He explained that he believes an ROE of 9.75% would provide a reasonable and fair rate of return in the current proceedings. Mr. Sommer supported his opinion by comparing the Company's current proposal to its proposed ROE in its last three rate cases and to the ROE authorized by the Commission in those cases, which averaged 9.75%.

Mr. Sommer also pointed out that Indiana-American filed rate cases and received orders from the Commission in 2004, 2007, and 2010. He noted that the Company also sought and successfully implemented a DSIC in the fall of 2010. Mr. Sommer opined that the Commission should consider the frequency with which Petitioner seeks increased rate relief and also should consider the time period over which these current rates will likely be in effect. Mr. Sommer suggested that Petitioner's history indicates that the rates that flow from this particular proceeding will in reality only cover a very short window of time. Mr. Sommer further supported his ROE by pointing out a material drop has occurred in the cost of debt for Petitioner

since its last rate case. This in turn suggests to Mr. Sommer that a drop in risk for this Petitioner has occurred, which would translate into a drop in the cost of equity.

(5) **Crown Point's Position.** Crown Point Witness, Mr. Gregory T. Guerrettaz, conducted DCF and CAPM analyses, and determined that 8.75% is a fair ROE for Petitioner. Mr. Guerrettaz testified that the cost of debt capital has substantially decreased since Petitioner's current 10% ROE was authorized, thus warranting an ROE lower than 10%. Mr. Guerrettaz noted that Petitioner's witnesses testified that Indiana-American has been able to reasonably attract capital from the market place at its current authorized ROE of 10%. Mr. Guerrettaz also explained that the supportive traditional regulation in Indiana, Petitioner's past successive base rate increases approximately every two years, and its ability to regularly adjust rates for significant transmission and distribution projects through the DSIC all help to protect and maintain cash flow and reduce risk. Next, Mr. Guerrettaz noted the attractiveness to investors of Petitioner's regulated water utility return and that American Water's equity enjoys a relative safe-haven-investment position during these turbulent, economic recessionary times.

Mr. Guerrettaz testified his proposed reduction in ROE from 10% to 8.75% is a reflection of the overall lower returns nationwide and the material decrease in the cost of debt. He noted that 10- and 30-year Treasury interest rates have declined by 1.78% and 1.54%, respectively, since Petitioner's last rate case and are projected to decrease further to 1.55% and 0.90%, respectively. He pointed out that reducing Petitioner's current ROE by the average of the historical and projected declines yields an ROE of 8.56%.

In addition, Mr. Guerrettaz relied on his application of DCF and CAPM analyses in reaching his proposed 8.75% ROE. Mr. Guerrettaz explained that his analysis differs from Mr. Moul's in that he has not included the leverage, flotation, and size adjustments in his cost of equity analysis. Mr. Guerrettaz used the same proxy group as Mr. Moul; however, Mr. Guerrettaz used a stable growth rate model in his DCF analysis while Mr. Moul used a two-stage growth model. Mr. Guerrettaz's DCF analysis concluded that the cost of equity ranged from 7.4% to 10.57%, with a simple average of 8.74%.

Mr. Guerrettaz also described his CAPM analysis. He pointed out that American Water enjoys a low financial assessment of risk, or beta, of .65, substantially below the average risk beta of 1.0. Mr. Guerrettaz's CAPM analysis employed the same betas as Mr. Moul. Mr. Guerrettaz explained that he gave weight to both the geometric and arithmetic mean risk premiums. His CAPM analysis yielded an arithmetic mean ROE of 7.93% and a geometric mean ROE of 6.75%. Mr. Guerrettaz concluded that an 8.75% ROE would be reasonable and would allow Petitioner to remain financially healthy.

(6) **Petitioner's Rebuttal.** In rebuttal, Mr. Moul testified that there is nothing in the testimony of Mr. Kaufman or Mr. Gorman that causes him to change his recommendation that the Commission find the Company's cost of common equity is 11.5%. Mr. Moul noted that both Mr. Kaufman and Mr. Gorman recommended an ROE that would be the lowest return by a significant margin of any state in which American Water will have continuing operations. He further stated that he is unaware of the Commission ever finding a cost of common equity for any public utility as low as the cost of common equity recommended by Mr. Kaufman in this case. He opined that if the Commission were to set the Company's cost of equity below 10%,

the financial community would become extremely concerned because such a return level is not sufficient to sustain utility operations or attract capital at a reasonable cost. He stated that volatility experienced in the capital markets in recent months confirms that equity investments are still perceived as being extraordinarily risky. As a measure of stock market volatility, Mr. Moul referred to the Chicago Board Options Exchange Volatility Index, which showed an average from July 1, 2011, through October 17, 2011, of 36.53, which is similar to the average annual index during the financial crisis. Mr. Moul opined that this level of risk of common stocks does not support the extraordinarily low equity returns suggested by Messrs. Sommer, Gorman, and Kaufman.

Mr. Moul referred to the AUS Utility Report's tabulation of authorized returns for the water utility proxy group, which averaged 10.06%. He explained that returns below these levels would not fulfill investor expectations. He stated that Janney Montgomery Scott, a major investment firm that closely follows the water utility industry for investors, ranks water companies and their respective regulatory commissions. The Commission is rated at the middle of the states that receive scores on water issues from Janney Montgomery Scott, which uses the ROE granted in rate case decisions as the foremost category considered in its ranking system. In its scoring system, Janney Montgomery Scott uses a 10.25% baseline return for ranking commissions with points added or deducted for returns that vary from the base. Janney Montgomery Scott deducts the maximum points for returns below 9.5%. Mr. Moul stated that the returns proposed by Messrs. Kaufman and Gorman, if accepted by the Commission, would provide a signal to the investment community of unsupportive regulation for Indiana water utilities.

In response to Mr. Sommer's testimony that the Company's ROE should be reduced from the 10% set in the Company's last case, Mr. Moul stated that Mr. Sommer's "fairness" and "balancing of interests" arguments are subjective and are not a substitute for the returns necessary to retain capital in the Company and obtain new capital. Mr. Moul explained that the frequency of the Company's rate cases is dictated by its large capital expenditures and unless internally generated funds increase to match those expenditures, rate increases are a necessary consequence of large new capital infusions (both debt and equity) into the Company. With respect to Mr. Sommer's argument that the availability of the DSIC to the Company should reduce the ROE, Mr. Moul stated investors already factor in the benefits of DSIC into their return expectations, given that the DSIC mechanism is prevalent in the water utility industry.

Mr. Moul testified that there is some consensus among the experts concerning the group of water companies that could be used to measure the cost of equity. He noted that both Mr. Gorman and he used the same eight-company Water Group in their analyses. He further noted that Mr. Kaufman also used these same companies, but added, in some instances, Artesian Resources to his group. Mr. Moul opined that Artesian's two classes of common stock, one of which does not have voting rights, presents a highly unusual situation that warrants exclusion of Artesian from his Water Group. He also noted that Mr. Kaufman has segmented his water group, but that there is no need to do so. Mr. Moul disagreed with the exclusion of American Water from Mr. Kaufman's smaller four-company group, because the cost of equity for American Water is particularly relevant given that it is the parent company of Indiana-American. Mr. Moul stated that Mr. Gorman also submitted a secondary group of natural gas utilities, but

that there is no need to consider gas companies as there are an adequate number of water companies.

Mr. Moul then described some of the limitations of the DCF models employed by Mr. Kaufman and Mr. Gorman. Mr. Moul stated that the "Gordon" form of the DCF model is not without its limitations because many of the assumptions that must be made to utilize this model are simply not realistic. These include constant and infinite growth and the assumption that earnings per share, dividends per share, book value per share, and price per share will all appreciate at the same constant rate absent any change in dividend payout and price-earnings multiple. He testified that the Gordon model does not account for, or reflect changes in, the variables that are common characteristics of the equity market. Indeed, according to Mr. Moul the evidence shows that these steady-state (i.e., constant growth) conditions represent unrealistic assumptions of investor expectations. Mr. Moul stated that this is shown by the dividend payout ratios calculated from the forecasts by Value Line for the water companies, which are forecast to decline in the future. Mr. Moul opined that with the forecasted trend of lower payout ratios, the use of dividend growth by Mr. Kaufman is particularly inappropriate for DCF purposes. As to the issue of book value per share growth, which Mr. Kaufman also presents, stocks do not trade at a constant market-to-book-ratio, thereby limiting the usefulness of this measure of growth.

Mr. Moul next discussed the financial variables that should be given the greatest weight when assessing investor expectations. Mr. Moul stated that he agreed generally with the Commission's preference for considering a variety of sources in the development of the DCF growth rate and that he has presented all of the variables that the Commission enumerated in the 2002 Rate Order. However, Mr. Moul believed that there is no justification for giving each of these variables equal weight. Mr. Moul testified that if a specific variable must be emphasized, then it is necessary to substantiate the reason for giving additional emphasis to that variable. He noted that the theory of DCF indicates that the value of a firm's equity (i.e., its share price) will grow at the same rate as earnings per share. Hence, the theory of DCF indicates earnings growth should be emphasized. Mr. Moul stated that dividends per share growth should not be emphasized because the payout ratios for the water companies are forecasted to decline. He also stated that book value cannot be emphasized because market-to-book ratios do not remain constant. Retention growth would likewise be inappropriate because it merely provides the individual components that cause book value per share to change. Therefore, Mr. Moul testified that in order to reflect investor expectations within the limitations of the DCF model, earnings per share growth, which is the basis of capital gains yield and the source of dividend payments, must be given primary emphasis.

Mr. Moul recognized that Mr. Kaufman removed negative rates from his growth analysis, but stated that Mr. Kaufman's mechanical averaging of the remaining growth rates does not conform to the specification of the DCF model he discussed previously. Mr. Moul opined that Mr. Kaufman has been inconsistent in his selection of variables in his DCF growth analysis. For example, Mr. Kaufman's constant growth form of the DCF model used earnings per share, dividends per share, and book value per share and gave each variable one-third weight. Yet when selecting his first-stage growth rate in his two-stage DCF, Mr. Kaufman used only earnings per share growth, thereby giving it 100% weight. Likewise, Mr. Kaufman gave one-half weight to historical growth in his constant growth DCF model, but gave 0% weight to historical growth in the first-stage growth rate of his two-stage DCF model. Mr. Moul stated that it must be

recognized that in developing a forecast of future earnings growth an analyst would first apprise himself/herself of the historical performance of a company. Hence, there is no need to count historical growth rates a second time, because historical performance is already reflected in analysts' forecasts, which reflect an assessment of how the future will diverge from historical performance.

Mr. Moul testified that Mr. Kaufman's 5.17% growth rate for the Value Line group is much too low. Mr. Moul stated that Mr. Kaufman failed to acknowledge that the magnitude of the growth rates cannot be assessed in isolation, but rather must be viewed in the context of the dividend yields because investors' expectation of growth must be synchronized with the price that is used for the dividend yield calculation. He noted that the fundamentals for water companies are different today than they were in 2003, when the NRRI article relied on by Mr. Kaufman was published. Mr. Kaufman also cited to the position of Steven G. Kihm that public utilities will grow significantly less than the economy as a whole. Mr. Moul asserted that this assumption is unrealistic because if Mr. Kaufman were correct, then the contribution of public utilities to growth in the overall GDP would continually decline, yet Mr. Moul was aware of no evidence supporting that notion. In fact, Mr. Moul stated that the evidence is to the contrary, indicating that utilities have contributed a relatively stable percentage relative to all industries to the GDP. This means that long-term growth for utilities cannot be significantly smaller than the growth of other corporations. Mr. Moul therefore concluded that it is unrealistic to believe that second-stage growth for utilities is capped at the GDP growth rate.

Mr. Moul next discussed Mr. Kaufman's two-stage DCF model. Mr. Moul stated that Mr. Kaufman's claim that the forecast growth rates in DCF models are unreasonably high disregards the information that is actually being used by investors in making their investment decisions. He also noted that Mr. Kaufman's criticism of analysts' forecasts is inconsistent with his presentation of analysts' forecasts in his DCF analysis. Mr. Moul opined that what is important is what investors actually use in their decisions regarding the purchase, sale or holding of stocks. The bottom line, according to Mr. Moul, is that the growth rate must be synchronized with the price that investors establish when valuing a stock in order for the DCF model to have any meaning as a representation of investors' required returns. Otherwise, the DCF result will be mis-specified, which is the case with Mr. Kaufman's result.

Mr. Moul explained that Mr. Kaufman's two-stage model adds complexity to the DCF and opens its application to further manipulation. He stated that Mr. Kaufman has understated the first-stage growth rate and that by including the Zacks forecasts, which Mr. Kaufman employed in the Company's prior rate case but omitted in this case without justification, the first stage growth rate is 6.31%. Mr. Moul asserted that use of a second-stage growth rate based on GDP is inappropriate in this case. Using the 6.31% first stage growth and 5.7% forecast growth in corporate profits (discussed below in response to Mr. Gorman's multi-stage DCF), Mr. Moul calculated a two-stage DCF result for Mr. Kaufman's inputs of 9.38%. Using Mr. Moul's 7.0% growth rate, the result is 9.53%. Both of these results are significantly higher than the 8.50% and 8.71% that Mr. Kaufman calculated.

Mr. Moul next discussed Mr. Kaufman's CAPM analysis. He stated that Mr. Kaufman presents a variety of CAPM calculations that are simply not credible because they provide returns that are either lower than or nearly equal to the cost of the Company's debt. Mr. Moul

opined that any cost of equity calculation that provides a result that nearly equals the yield on a public utility bond is unreliable. Mr. Moul agreed that the Value Line betas used by Mr. Kaufman can be used as a starting point in the analysis, but maintained that they must be unlevered and re-levered for the same reasons indicated with regard to the DCF, i.e., for the leverage difference between the market and book value capitalization. Mr. Moul stated that the Hamada formula that he used to leverage-adjust the betas is merely an extension of the Modigliani and Miller formula that he used in the DCF calculation.

Mr. Moul stated that the arithmetic mean should be used to the exclusion of the geometric mean in the CAPM, and that the theory of the CAPM requires this choice. He testified that the arithmetic mean provides the correct representation of all probable outcomes and has a measurable variance, unlike the geometric mean used by Mr. Kaufman which consists merely of a rate of return taken from two data points. Mr. Moul stated that, contrary to Mr. Kaufman's testimony, the Ibbotson Yearbook carefully explains the rationale for using the arithmetic means in a single period model, such as the CAPM. Mr. Moul stated that there is no relevance to Mr. Kaufman's reference to a twenty-five-year-old article that does not even discuss the CAPM because the current Ibbotson Yearbook is very clear on this point. Mr. Moul opined that because the geometric mean does not fulfill any role in determining the market premium component of the CAPM, it certainly should not be given 50% weight but rather should be discounted to the greatest extent possible.

Mr. Moul criticized Mr. Kaufman's use of a constant 5.25% market premium in relation to Treasury bond yields as being well off the mark. When combined with Mr. Kaufman's risk-free rates of return, Mr. Kaufman has postulated total market return of 9.2% to 9.4%. Mr. Moul opined that a 9.2% to 9.4% overall return for the market is unreasonable given that it is less than or equal to the DCF return that Mr. Kaufman calculates for his AUS water proxy group which is less risky than the total market.

Mr. Moul then defended his adjustment to the CAPM to compensate for the risk associated with small size. He stated that Mr. Kaufman's arguments revolve around a statement by the Commission in a 1997 sewer rate case and articles published in 1999 and 1993. As to the Commission order, Mr. Moul indicated that it seemed troubled by the large 400 basis point size adjustment. In this case, Mr. Moul used a 1.20% midcap size adjustment, even though a larger 1.98% low cap adjustment was justified. He believed that his conservative approach to the size adjustment satisfies the Commission's concerns in the sewer case Mr. Kaufman cites, as well as the 1999 article. As to Mr. Kaufman's reliance on the 1993 *Wong* article, Mr. Moul noted that the article employed data going back into the 1960s. Mr. Moul stated that enormous changes have occurred in the utility industry since the 1960s that have fundamentally changed the utility business. Mr. Moul opined that the conclusions in the *Wong* article do not invalidate the additional risk associated with small size. Moreover, Mr. Moul pointed out that the *Wong* article erroneously used betas to reach its conclusion because beta is not designed to measure the influence of size on a company's risk.

Mr. Moul then responded to Mr. Kaufman's criticism of the risk premium approach and in particular Mr. Moul's use of median values and arithmetic means. He testified that medians are a well accepted measure of central tendency that can be found in any basic statistics

textbook. He noted that Mr. Gorman correctly used the arithmetic mean in his application of the CAPM.

Mr. Moul defended his Comparable Earnings approach, stating that the Comparable Earnings approach satisfies the comparability standard established in the *Bluefield* decision and reflects the view of the financial community that the regulatory process must consider the returns that are being achieved in the non-regulated sector to ensure that regulated companies can effectively compete in the capital markets.

Mr. Moul responded to Mr. Gorman's testimony. He stated that he had some of the same issues that he discussed concerning the testimony of Mr. Kaufman, such as ignoring the element of flotation costs, the adjustment that is necessary to make the DCF cost rate applicable in the rate-setting context, and the size adjustment to the CAPM. He first addressed Mr. Gorman's testimony that American Water's bond rating is a reasonable proxy for Indiana-American's bond rating and that American Water is a reasonable risk proxy for Indiana-American. Mr. Moul explained that Indiana-American's interest coverage ratios are significantly below those of the companies in the proxy group and lower interest coverage ratios make a company's debt riskier. He explained that since debt instruments are more secure than equity, the fact that Indiana-American has lower interest coverage ratios means that its cost of equity is necessarily higher. He stated that although Indiana-American may be able to access the debt markets through American Water at cheaper rates than it would attract on its own, this does not mean that Indiana-American's risk is equal to that of American Water. Mr. Moul disagreed that Indiana-American has a higher interest coverage ratio than the proxy group.

Mr. Moul responded to Mr. Gorman's conclusion that Indiana-American's customers should receive the benefits of American Water's larger size due to their affiliation with American Water. He stated that the economies of scale provided by American Water Works Service Company, Inc. (the "Service Company") would suggest that services obtained from the Service Company would be available at lower costs to Indiana-American, and that an enhanced level of expertise is available from the Service Company. Accordingly, Mr. Moul disputed Mr. Gorman's assertion that without adjusting the cost of equity, customers do not receive the benefits of the American Water affiliation although they pay the costs.

Mr. Moul stated that Mr. Gorman's DCF results in several instances that are simply not credible. For example, he indicated that DCF results of *negative* 1.16% for Middlesex Water cannot possibly provide a reliable measure of its cost of equity. In addition, the numerous DCF returns below 9% shown on Industrial Group Exhibit MPG-5 are outside the range of reasonable returns. Mr. Moul testified that Mr. Gorman's use of a two-stage DCF approach essentially contradicts Mr. Gorman's own testimony, and depresses his DCF results by approximately two percentage points (e.g., 10.77% to 8.96%) for the Water Group. Mr. Moul disagreed with Mr. Gorman's concerns about analysts' forecasts and the results of his constant growth DCF model. Mr. Moul reiterated that the growth rate must be synchronized with the price that investors establish when valuing a stock in order for the DCF model to have any meaning as a representation of investors' required returns. Mr. Moul testified that Mr. Gorman's sustainable growth form of the DCF does not provide a reasonable cost of equity in this case. He stated that there are serious limitations in this approach. Mr. Moul opined that book value per share growth, or its surrogate retention growth, does not represent the proper financial variable to be

considered when selecting the DCF growth component because utility stocks do not typically trade at book value.

Mr. Moul stated that there are specific problems with the sustainable growth method proposed by Mr. Gorman. He observed that Mr. Gorman's input values were taken from Value Line reports and represent forecasts covering the period 2014-2016. Thus, Mr. Gorman's projections are for a very specific period and have not been shown to be sustainable beyond that point. Further, Mr. Gorman's approach to sustainable growth ignores investors' expectations for 2011-2013 and the growth that will occur during that period. Mr. Moul commented on Mr. Gorman's assertion that analysts' growth rates for water companies are abnormally high. He stated that there are several reasons that explain the current analysts' growth forecasts for water utilities and that growth rates cannot be viewed in a vacuum. Mr. Moul explained that high growth stocks often have low dividend yields and vice versa and that the combination of growth and yield, which is determined from the price, provides the DCF cost of common equity rate.

Mr. Moul stated that there are objective measures that could be used to determine whether or not to employ a two-stage DCF. He explained that FERC has set forth specific criteria to be applied when deciding whether to employ the two-stage DCF model: (i) a dividend payout ratios analysis; (ii) an assessment of electric utilities relative to other industries; and (iii) whether analysts' forecasts were two to three times greater than GDP growth. Mr. Moul found that the dividend payout ratios of the water utilities do not approach the 20%-30% levels for other, mostly non-regulated industrial companies, where the two-step DCF model has been used. Thus, based on criteria employed by FERC, Mr. Moul stated that application of a two-stage growth rate in the DCF analysis is unsupported.

With respect to the technical aspects of Mr. Gorman's proposed two-stage DCF, Mr. Moul again criticized his assumption of a 200-year investment horizon. Mr. Moul testified that when the FERC uses a two-stage DCF model for natural gas pipelines, it weighs the analysts' growth rate (i.e., first-stage growth) two-thirds (66.7%) and second-stage growth one-third (33.3%) in the case of corporations. Additionally, FERC's application of the two-stage model removes the additional complexity that exists by inserting, as Mr. Gorman did, transitional growth for years 6 through 10. Mr. Moul stated that if Mr. Gorman had employed FERC's methodology, his two-stage DCF result would be 11.06%, after removing the anomalous results for Middlesex Water.

Mr. Moul expressed his concerns regarding the CAPM application by Mr. Gorman. He stated that Mr. Gorman properly used the arithmetic mean market premium of 6.7% from the Morningstar study, but then neglected to incorporate forecasts of market returns in the development of his market premium. Mr. Moul testified that forecasts of market returns are necessary to comply with the "ex ante" specification of the CAPM, as market models of the cost of equity are a reflection of the forward-looking nature of investor return expectations. Mr. Moul noted that those returns average 15.56%, thus producing a market premium of 11.36%, which is considerably higher than the 6.7% or the alternative 6.5% market premiums used by Mr. Gorman.

Mr. Moul next commented on Mr. Gorman's risk premium approach. He opined that, for a variety of reasons, this type of risk premium study provides only limited evidence of the cost of

equity. He observed that the historical periods selected by Mr. Gorman are arbitrary, and that by shortening his time period progressively higher risk premiums would result when using the yields on Treasury bonds and utility bonds. For example, Mr. Moul stated that the five year average 2007 through 2011 period, and the ten-year average 2002 through 2011 period indicates that the risk premium would be higher than Mr. Gorman's averages. He pointed out that this type of risk premium study also mixes "authorized gas returns" on book value with market-determined yields based on Treasury bonds and utility bonds, and thus employs non-comparable variables and does not provide a reliable measure of the risk premium. Mr. Moul testified that there is a potential for mismatch of time frames between Mr. Gorman's tabulation of the "authorized gas returns" and the yield on Treasury bonds and utility bonds. He explained that this failure arises because there is a time lag between the development of the evidentiary record in a rate case proceeding and the issuance of an order by a regulatory agency, unlike the yield on Treasury bonds and utility bonds, which are measured after-the-fact.

Mr. Moul also testified that there is no telling how the "authorized gas returns" may have been influenced by regulatory policy or political factors. He explained that a regulatory agency may employ the "authorized gas returns" as a tool to reflect policy decisions in other rate-setting areas such as interim rates, rates collected subject to refund, use of historical or future test periods, use of average or year-end rate bases, various procedures to calculate depreciation, allowances or disallowances of certain operating costs, and a host of other regulatory practices. Moreover, Mr. Moul asserted that it is well known that regulatory agencies have used the "authorized gas returns" as a means of accomplishing certain goals, such as rewarding or penalizing management performance, and thus it is impossible to determine whether these "authorized gas returns" in fact represent investor-required returns for the time periods in which those decisions were rendered. Given all of the unknown factors that influence "authorized gas returns," he opined that Mr. Gorman's approach employs an unsuitable benchmark to measure the equity risk premium. Using the yields on utility bonds and Treasury bonds proposed by Mr. Gorman, Mr. Moul stated that the cost of equity would be 10.01%.

Mr. Moul noted that Mr. Gorman's CAPM analysis also failed to include the flotation cost adjustment and neglected to adjust the beta for the financial risk adjustment associated with the differences in market capitalization and book value capitalization. He stated that the beta used by Mr. Gorman was taken directly from Value Line without the necessary modification to synchronize it with the book value capitalization. He further stated that Mr. Gorman failed to include the size adjustment, which is indicated to be 1.20% and would bring his CAPM result to 10.59% with flotation costs.

Petitioner's witness James I. Warren, a tax partner in the law firm of Winston & Strawn, LLP, responded to Mr. Kaufman's characterization of Petitioner's income tax position and the impact, if any, on the cost of equity. He first disputed that Petitioner's position is unique, given the advent of bonus depreciation and the change in method most utilities have elected with regard to the repairs deduction. He then clarified that the income tax position impacts the overall cost of capital, and that this impact is fully reflected in the capital structure by including deferred taxes at zero cost. He explained that to suggest that it also impacts the cost of equity is to double-count deferred taxes.

Mr. DeBoy testified that Petitioner must increase the replacement rate of its distribution system. The current rate of replacement (0.7% which calculates to a lifespan of 143 years) is beyond the expected useful life of water mains. He testified that it is critical the Commission approve a reasonable ROE because the Commission's finding will be applicable in future DSIC filings.

(7) **Commission Discussion and Findings.** The record contains a number of different methods of estimating Petitioner's cost of common equity, resulting in cost of equity recommendations ranging from 8.60% to 11.50%, with an average of 9.60%. We recognize the cost of common equity cannot be precisely calculated and estimating it requires the use of judgment. Due to this lack of precision, the use of multiple methods is desirable because no single method will produce the most reasonable result under all conditions and circumstances.

In the 2010 Rate Order, the Commission concluded Indiana-American's cost of equity was 10.00%. 2010 Ind. PUC LEXIS 155, at *145. Yields on 30-year U.S. Treasury bonds began falling just prior to the 2010 Rate Order, from a high of 4.84% in April 2010 to a low of 3.53% in August 2010. Since then, yields steadily climbed to 4.76% in February 2011, but began to fall after S&P downgraded U.S. sovereign debt. The Commission questioned Mr. Moul regarding the Treasury yield, and he indicated that Treasury yields have declined since his initial testimony and have remained around 3%. As Mr. Gorman pointed out, a similar downward trend has occurred for "A" and "Baa" utility bonds: yields on "A" bonds have decreased 1.02% and yields on "Baa" bonds have decreased 0.88% from April 2010 to September 2011. While not an exact correlation, there is a positive relationship between cost of equity and interest rates. Based on the general downward trend since Petitioner's last rate case, the Commission believes it would be unreasonable to find that Petitioner's cost of equity is higher than 10%.

Similarly to his analysis in Cause No. 43680, Mr. Moul's analysis here suffers from the use of an unusually high growth rate (7.00%) and a high market premium (6.86%). In addition, Mr. Moul's analyses used leverage adjustments, flotation cost adjustments, and small company adjustments. In Cause No. 43680, we found that these adjustments were inappropriate, and we reiterate that finding here. For example, in the 2010 Rate Order, when discussing flotation costs we stated: "The Commission will only allow such an adjustment when it is based on verifiable actual costs so that the reasonableness and appropriateness of the costs may be examined." 2010 Ind. PUC LEXIS 155, at *140. In this Cause, Petitioner again did not produce evidence of actual costs. In fact, Mr. Moul stated these costs are not traceable because the costs are not pushed down to the subsidiaries when American Water issues equity.

However, the Commission agrees with Mr. Moul that in this Cause the market-based models such as CAPM and risk premium produced unusually low results. For example, using a risk free rate of 4.00%, a beta of 0.74, and an equity risk premium of 5.25% yields a cost of equity of 7.89% in the CAPM, which is too low to be reasonable. Similarly, the risk premium model using a current yield on "A" rated utility bonds of 4.55% and the equity risk premium of 3.95%, produces a cost of equity of 8.50%, which is also too low to be reasonable.

With respect to DCF analyses, the Commission has considerable experience with the DCF model for estimating the cost of equity, and is well aware of the advantages and limitations of the various approaches used by each of the witnesses. The Commission believes that both

historical and forecasted earnings and dividends and book value per share data are useful when employing the DCF model. Petitioner's DCF analysis yielded an average cost of equity, when the leverage and flotation cost adjustments are removed, of 10.42%: Mr. Kaufman's range was 8.4% to 9.45%, with an average of 8.925%: Mr. Gorman's average was 9.5%: Mr. Guerrettaz's average was 8.74%.

When comparing the Parties' ROE proposals from Cause No. 43680 to those in this Cause, each of the Parties has proposed a lower cost of equity than in Cause No. 43680: Indiana-American – 0.5%; Schererville – 0.25%; Industrial Group – 0.5%; OUCC – 0.65%. In addition, Indiana-American's cost of debt has declined by 0.44% from 6.96% in Cause No. 43680 to 6.52% in this Cause. As a result, we believe that a decrease in Petitioner's ROE from the 10% authorized in the 2010 Rate Order, is warranted. Based on our discussion above, the Commission finds that a reasonable range for Petitioner's cost of equity is 9.50% to 10.00%, and we conclude that a 9.70% ROE equity is fair and reasonable.

B. Deferred Taxes.

(1) **OUCC's Position.** Mr. Ralph Smith, Senior Regulatory Consultant at Larkin & Associates, testified on income tax issues for the OUCC. Mr. Smith noted that American Water implemented a major tax accounting change for repairs deductions on its federal income tax return for tax year 2008, which affected Indiana-American by reducing its federal taxable income. Mr. Smith noted the decrease in taxable income reduced the Company's current taxes payable while increasing deferred income tax expense and the accumulated deferred income tax ("ADIT") liability. Mr. Smith explained that the increase in the Company's accumulated deferred income tax liability represents an increase to the ADIT component of the capital structure. However, the total income tax expense remained unchanged. The increase in deferred income tax expense is debited to deferred income tax expense and credited to ADIT, which is a balance sheet liability account. Mr. Smith explained that, for ratemaking purposes, the ADIT balance is treated as a component of non-investor supplied funds (similar to a government non-interest bearing grant) and is reflected at zero cost in the capital structure. Mr. Smith's testimony indicated that on Petitioner's 2008 federal income tax return, substantial amounts of income tax savings were realized by claiming repairs deductions using the new tax accounting method. He added that the actual income tax savings realized by the Company from the repairs deduction tax accounting method change represents a source of capital to the Company and should therefore be reflected in the capital structure.

Mr. Smith noted that Indiana-American's response to OUCC Data Request 43-017 stated the total amount of repairs deductions claimed by the Company on its 2008 through 2010 tax returns was \$79,322,471. Mr. Smith argues, however, that Indiana-American's evidence does not fully reflect the normalized amount of tax savings resulting from the repairs deductions. Mr. Smith stated that the ADIT balance proposed by the Company is understated by approximately \$9.247 million.

Pursuant to Financial Accounting Standards Board Interpretation No. 48 ("FIN 48"), Petitioner evaluated its uncertain tax position and established a liability under FIN 48 for financial reporting purposes. Mr. Smith noted that during the test year, the Company accrued relatively small amounts of interest on its uncertain income tax positions – \$13,044 for 2009 and

\$19,408 for 2010. The FIN 48 interest is for accrual accounting only and has not been paid. The FIN 48 interest represents the net carrying costs that Indiana-American recorded in those years for the portion of the repairs deductions under the new tax accounting method that it views as an uncertain tax position.

Mr. Smith explained that the FIN 48 account balance should either be treated as zero cost capital or as capital with interest associated with it, and, if the latter, the best measurement of that interest cost is the FIN 48 interest that the Company has actually recorded on its books. Mr. Smith testified that treating the FIN 48 balance as zero cost capital is consistent with the Company's financial accounting for it, where the Company is required under Generally Accepted Accounting Principles ("GAAP") to record interest expense on the FIN 48 liability if it believes that it's going to be subject to an interest assessment by the IRS.

Based on information Petitioner provided in discovery, Mr. Smith estimated the FIN 48 liability on June 30, 2011 to be \$9.247 million and he recommended that this amount be included in Petitioner's capital structure at zero cost, or, alternatively, with a cost based on the related FIN 48 interest that has been recorded by the Company during the test year. He testified that this Commission has not adopted FIN 48 for regulatory purposes and that the Commission should decline to do so now as this would unnecessarily increase utility rates by failing to fully reflect deferred income taxes for the actual tax benefits that have been claimed on the tax returns. He testified that the Company has not paid taxes with respect to the FIN 48 amounts and has benefited from these uncertain tax positions. As a result, the tax savings realized from the uncertain tax positions should be viewed similarly to a grant from the federal and state government. If the uncertain tax positions ultimately are resolved in the Company's favor, it will have had the use of this money at zero cost. If the position is ultimately disallowed, Mr. Smith testified that the Company will have to pay the taxes with interest. He also testified that it is likely the ultimate outcome of the uncertain tax position will be resolved somewhere in the middle, where the Company will have the use of part of the savings but not all. He explained that under no scenario would it be fair or appropriate to charge ratepayers the overall rate of return by failing to reflect the significant source of funds as additional ADIT or non-investor provided capital in the capital structure.

(2) **Petitioner's Rebuttal.** Mr. James Warren testified in rebuttal to Mr. Smith's proposed FIN 48 adjustment to the capital structure. He provided a summary of tax normalization and the timing differences that cause income tax expense for accounting purposes to differ from income taxes paid in any given year as reported on the tax return. He described the difference between two types of government loans made through the tax code. The first type is an ADIT cost-free loan and the second is a non-cost-free non-ADIT loan. The ADIT loan is what results from the timing differences inherent in normalization. The utility claims accelerated depreciation on its tax return and, by virtue of that fact, reduces its tax liability. The reduction in the utility's tax liability gives rise to the ADIT loan. Mr. Warren testified that, indeed, the Congressional purpose in enacting accelerated depreciation was to extend ADIT loans to businesses. The repayment of the loan is accomplished by filing future tax returns that reflect incremental taxable income because there is less tax depreciation. Because the loan is repaid to the government by the filing of future tax returns, there is no interest associated with it. It remains interest free as long as it is outstanding and this is the reason why deferred taxes are reflected in the capital structure at zero cost. He described the non-ADIT loan as arising when

the utility claims a deduction on the tax return to which it ultimately is not entitled. In that event, the deduction will reduce its tax liability for that particular year and thereby creates a government loan. Once the deduction is disallowed, the utility will have to pay back the loan immediately with interest. This second type of loan is not a part of a Congressional subsidization scheme. Interest will accrue from the date the utility files its tax return. There is no period during which such a loan is interest-free.

Mr. Warren explained that the purpose of FIN 48 is to make order out of chaos. FIN 48 prescribes the way in which companies must analyze, quantify, and display the consequences of tax positions that are technically uncertain. The tax law is exceedingly complex and contains many provisions that are subject to more than one interpretation, and business transactions can frequently be viewed in more than one way. FIN 48 prescribes a single standard, a single process, and a single disclosure regimen for uncertain tax positions taken by a taxpayer. The taxpayer must identify all of its "tax positions," and must evaluate the degree of uncertainty of each one. The evaluation process is extremely rigorous and results in a determination of the amount of tax that more likely than not must be paid to taxing authorities in connection with uncertain tax positions. FIN 48 does not permit this amount to be reflected as ADIT. In short, the FIN 48 amount represents the incremental quantity of tax that the Company and its auditors have concluded will most likely be owed with respect to previously filed tax returns. These amounts will be payable with interest when they are assessed if the tax position is ultimately disallowed by the IRS.

Mr. Warren testified that all companies with publicly traded securities must comply with FIN 48. Because of the adverse earnings implications of designating amounts as FIN 48 amounts, no company has an incentive to designate a larger FIN 48 amount than FIN 48 requires. He testified that a FIN 48 balance represents amounts that experts have determined will likely have to be paid to the taxing authorities with interest and should not be reflected as ADIT. Otherwise, ratepayers will see a reduction in the weighted overall cost of capital that the FIN 48 process has concluded is neither real nor sustainable. He testified that while admittedly it is not absolutely certain that all of the loans identified as FIN 48 amounts will be payable, it is even less likely that those loans will be interest-free.

Mr. Warren testified that the Commission should encourage the Company to take uncertain tax positions because if, contrary to the expectations of the experts, the Company is able to prevail in the assertion of an uncertain tax position, at that point the loan would be characterized as an ADIT loan and customers would enjoy incremental zero-cost capital in the next rate proceeding. Consequently, it is in the customers' best interests for the Commission to encourage such positions. Mr. Warren also took issue with the amount of the FIN 48 balance reflected by Mr. Smith. He testified that the FIN 48 balance at the end of 2010 was estimated at that time, and it was subsequently trued-up to reflect the tax returns as filed for 2008 and 2009. The corrected amount was \$6.7 million. He also explained that because the Company has a net operating loss carryover ("NOLC"), some portion of the uncertain deduction claimed on the Company's tax return did not produce any cash – those deductions merely increased the NOLC. The Company recorded this failure to actually defer any tax as a debit in its ADIT account. The amount of the debit was \$0.75 million. He testified that the current FIN 48 balance should be \$5.95 million.

(3) **Commission Discussion and Findings.** To fully understand the FIN 48 issue it is important to review normalization tax accounting. Timing differences between financial reporting and tax accounting, such as those created by accelerated depreciation and the repairs method change, are normalized for ratemaking purposes and the difference held (either as a credit or debit) in ADIT as zero cost capital. In the Muncie Remand Order, the Commission defined “permanent differences” as differences (such as income from government securities, which is exempt from federal tax) “applicable to a given tax period whose tax consequences will never reverse over time.” 1981 Ind. PUC LEXIS 246, at *14. The Commission defined “timing differences” as differences (such as accelerated depreciation) “applicable to a given tax period but whose tax consequences will reverse themselves in subsequent tax periods.” *Id.*

The Commission went on to state:

The concept or principle which recognizes and accounts for the timing differences between the periods in which transactions affect taxable income and the periods in which such transactions affect the determination of pre-tax book income is known as comprehensive inter-period tax allocation, or commonly referred to as “normalization”, and is a form of accrual accounting by which the tax expense liability is recorded in the proper taxable period even though actual cash payment therefor will not occur until later taxable periods.

The difference between such amount of tax expense liability recorded and actual cash tax payments for any given taxable period results from timing difference adjustments, such as accelerated depreciation, to taxable income and the deduction of investment tax credits.

The use of timing difference adjustments, such as accelerated depreciation, to taxable income reduces the actual tax liability for any given taxable period, but such reduction is not of a permanent nature so as to result in a tax avoidance or permanent tax “savings.” In subsequent taxable periods, over the life of the capital asset which was the basis for such timing difference adjustments, the actual tax liability will increase due to the lesser amount available as a tax deductible expense.

When the tax consequences of such timing difference adjustments are “normalized”, for rate-making purposes, the difference between the actual tax liability, taking advantage of such adjustments, and the larger amount of what the tax liability would have been without such adjustments is deferred and recorded in deferred tax reserve accounts. Thereby, the deduction of expenses to determine income tax expense, for rate-making purposes, is as if the timing difference adjustments to taxable income had not been made. In later years, over the life of the asset, when the deduction to taxable income decreases due to the larger deduction in the earlier years of the asset, a proportionate amount of the deferred tax reserve, attributable to the capital asset, is applied so as to reduce the recorded tax expense liability for rate-making purposes.

* * * *

The use of normalization accounting principles permits an entity to equalize the tax consequences resulting from timing difference adjustments, such as accelerated depreciation, to taxable income and investment tax credits, associated with capital assets, over the useful life of the assets, and consequently, when such normalization is utilized for rate-making purposes, the present and future utility customers share such tax consequences equally over the life of the assets that are used to provide the utility service.

Id., at *15-19. Both of the expert tax witnesses in this proceeding were in agreement that normalization is the appropriate regulatory treatment of timing tax differences such as those that are created by accelerated depreciation and the repairs method change.

With that background, we now address the ratemaking treatment for the FIN 48 balance, which represents the “uncertain” portion of the repairs deductions taken by the Company. In 2008, the Company changed its tax accounting method for repairs. For the test year, the only “uncertain” tax position, and the only item for which Indiana-American has recorded a FIN 48 reserve, is for repairs deductions. According to Petitioner’s accounting records, the FIN 48 balance on December 31, 2010 was \$9.449 million.

Petitioner asserts that the “uncertain” portion of its repairs deductions should have no effect on its regulatory capital structure. The OUCC argues that repairs deductions result in non-investor supplied capital that should be recognized in the capital structure either as zero cost capital (similar to other ADIT) or as a form of non-investor supplied capital that requires an interest cost.

The money resulting from the lower income taxes that resulted from the repairs deductions claimed by the Company is available for any use to which the Company wants to put it, and is therefore similar to other sources of non-investor supplied capital. Ignoring this source of non-investor supplied capital altogether as Indiana-American advocates is not reasonable. Reflecting the full impact of the repairs deductions, including the “uncertain” portion as non-investor supplied capital is reasonable since the Company has the use of that money and can use it for any use that it wishes.

We conclude that the balance of Indiana-American’s FIN 48 account on December 31, 2010, \$9,448,727, shall be included in its weighted cost of capital.

C. Overall Weighted Cost of Capital. Based on these findings and after giving effect to the ROE we authorized above, we find that Petitioner’s capital structure and weighted cost of capital is as follows:

Description	Amount	Percent Of Total	Cost Rate	Weighted Cost
Long Term Debt	\$ 313,596,520	43.77%	6.52%	2.86%
Common Equity	301,014,743	42.01%	9.70%	4.08%
Preferred Stock	210,000	0.03%	6.00%	0.00%
Post Retirement Benefits, net	2,513,672	0.35%	0.00%	0.00%
Deferred Income Taxes	88,314,099	12.33%	0.00%	0.00%
FIN 48 Liability	9,448,727	1.32%	0.00%	0.00%
Job Development ITC-Post 1970	1,247,384	0.17%	8.08%	0.01%
Deferred ITC-Pre 1971	36,633	0.01%	0.00%	0.00%
Accum. Depreciation-Muncie Sewer	62,889	0.01%	0.00%	0.00%
Total	\$ 716,444,667	100.00%		6.95%

D. Fair Rate of Return and Net Operating Income.

(1) **Petitioner's Position.** Mr. Moul provided an analysis by which the Commission can derive a fair return on fair value based on the Commission's procedure in Cause No. 43624 where we reduced the cost of equity by the prospective rate of inflation that is reflected in the cost of equity. Mr. Moul reduced the Company's 11.50% cost of equity by a prospective rate of inflation of 2.35% based on the difference between the nominal yield on 20-year Treasury bonds and the corresponding yield on inflation-indexed Treasury bonds having a similar maturity. A rate of return of 6.80% is indicated when the cost of equity is adjusted for prospective inflation and Mr. Moul opined that a return of 6.80% on the Company's fair value rate base would be fair and reasonable.

Mr. VerDouw explained how the Company arrived at its proposed net operating income. Consistent with how this Commission has dealt with the acquisition adjustment resulting from the acquisition of Indiana Cities Water Corp. ("Indiana Cities AA"), Mr. VerDouw computed a net original cost return based on the weighted cost of capital, and to that he added a fair value increment derived from applying the weighted cost of capital to the remaining unamortized balance of the Indiana Cities AA. This produced a requested authorized net operating income of \$57,969,265. Mr. VerDouw then conducted reasonableness tests as applied to the Company's request. Mr. VerDouw conducted his analysis independently of Mr. Moul's. He started with the updated fair value finding from Petitioner's last litigated rate case. He then computed three different fair rates of return on that fair value, based on the Commission's high end, low end and ultimate finding of fair rate of return from the 2010 Rate Order. The first fair rate of return calculated by Mr. VerDouw corresponds to the upper end of the range of fair returns found by the Commission in Cause No. 43680. This rate of return was calculated by deducting historical inflation from the weighted cost of debt over the weighted average life of Petitioner's utility plant in service. Mr. VerDouw used an average age of plant weighted by the original cost of approximately 14 years as provided by Mr. Hoffman in his direct testimony. Utilizing the inflation rate of 2.4% from the Ibbotson Yearbook for the years 1996 through 2010 and deducting that from the weighted cost of debt produced a fair rate of return of 6.72% and a required net operating income of \$75,701,026.

Mr. VerDouw's second test computed the fair rate of return in the same manner that the Commission computed the low end of its range in Cause No. 43680, which is to remove historical inflation from the overall weighted cost of capital. This produced a rate of return of 5.40% and a required net operating income of \$60,831,182.

Mr. VerDouw's third test was derived from an approximation of the point between the two ends of the range found in Cause No. 43680. In the 2010 Rate Order, the fair value range was 5.03% on the low end to 6.40% on the high end, or a total spread of 137 basis points. The Commission determined Indiana-American's fair value rate of return was 5.32%, which is 29 basis points above the low end of our fair value range. Mr. VerDouw, employed the same methodology to calculate a fair rate of return of 5.69%, which is 29 basis points above the low end of 5.40% as calculated in Mr. VerDouw's second reasonableness test. This produces a required net operating income of \$64,098,041.

(2) **Industrial Group's Position.** The only opposing witness to submit evidence on fair return on fair value was Mr. Gorman, who testified that the fair return on fair value should be approximately equal to the amount produced by net original cost rate base and weighted average cost of capital.

(3) **Petitioner's Rebuttal.** Mr. VerDouw testified that Indiana is a fair value jurisdiction and that, as applied to Indiana-American, Mr. Gorman's argument that the authorized return should be the same using an original cost rate base and a fair value rate base is inconsistent with the fair value ratemaking applied to the Indiana Cities AA, which has been approved in several litigated rate cases, most recently in Indiana-American's last rate case when the Commission rejected Mr. Gorman's arguments against it. He further noted that no party, including Mr. Gorman, submitted any testimony challenging any of the reasonableness tests presented in Mr. VerDouw's direct testimony.

(4) **Commission Discussion and Findings.** The cost of capital is a percentage which can be converted into an earnings requirement only by applying that percentage to a rate base. In *Duquesne Light Co. v. Barasch*, the Supreme Court held that the U.S. Constitution does not require the adoption of a single theory of valuation. 488 U.S. 299, 316 (1989). "The Constitution within broad limits leaves the States free to decide what ratesetting methodology best meets their needs in balancing the interests of the utility and the public." *Id.* Indiana has selected the fair value rate base methodology. The Supreme Court described the fair value approach as follows:

Under the fair value approach, a "company is entitled to ask ... a fair return upon the value of that which it employs for the public convenience," while on the other hand, "the public is entitled to demand ... that no more be exacted from it for the use of [utility property] than the services rendered by it are reasonably worth." ... In theory the *Smyth v. Ames* fair value standard mimics the operation of the competitive market. To the extent utilities' investments in plants are good ones (because their benefits exceed their costs) they are rewarded with an opportunity to earn an "above-cost" return, that is, a fair return on the current "market value" of the plant. To the extent utilities' investments turn out to be bad ones (such as plants that are canceled and so never used and useful to the public), the utilities

suffer because the investments have no fair value and so justify no return.

Id. at 308-309 (quoting *Smyth v. Ames*, 169 U.S. 466, 547 (1898)).

As we have in previous rate orders, we will use the following standards and criteria to determine a fair rate of return on Petitioner's investment in its utility plant:

- 1) Return comparable to return on investments in other enterprises having corresponding risks;
- 2) Return sufficient to ensure confidence in the financial integrity of the Petitioner;
- 3) Return sufficient to maintain and support the Petitioner's credit [rating];
- 4) Return sufficient to attract capital as reasonably required by the Petitioner in its utility business.

One recognized method for evaluating the reasonableness of a utility's allowed return involves investigation of the utility's capital structure. From such investigation, we can develop the overall weighted cost of capital. This cost of capital may then be considered in determining a fair return. Having previously determined that the fair value of Petitioner's rate base is \$1,051,885,770 it is now our duty to determine a fair rate of return that can be used to calculate a fair dollar return for Petitioner's net operating income.

As our supreme court determined *City of Indianapolis*,

The ratemaking process involves a balancing of all these factors and probably others; a balancing of the owner's or investor's interest with the consumer's interest. On the one side, the rates may not be so low as to confiscate the investor's interest or property; on the other side the rates may not be so high as to injure the consumer by charging an exorbitant price for service and at the same time giving the utility owner an unreasonable or excessive profit.

131 N.E.2d at 318. Therefore, the results of any return computation may be tempered by the Commission's duty to balance the respective interests involved in ratemaking. The end result of the Commission's Orders must be measured as much by the success with which they protect the broad public interest entrusted to our protection as by the effectiveness with which they allow utility's to maintain credit and attract capital.

This Commission has asserted in previous rate cases, insofar as the fair value rate base contains historical inflation, that it is historical inflation and not prospective inflation that should be removed from the cost of capital to estimate a fair rate of return. Mr. VerDouw determined the inflation rate by calculating the historical inflation over the weighted average life of Indiana-American's plant in service, which according to Mr. Hoffman was approximately 14 years. According to the Ibbotson Yearbook, the historical inflation rate for the years 1996 through 2010 was 2.40%.

Using the 2.40% historical inflation rate to remove inflation values from Indiana-American's overall cost of capital yields a fair value rate of return of 4.55% (6.95% - 2.40%). Removing inflation from Indiana-American's cost of debt and plugging the new cost of debt into

the capital structure yields a fair value rate of return of 5.90%. Accordingly, the range for Petitioner's fair value rate of return is 4.55% - 5.90%. Based on the evidence presented, the Commission finds the fair value rate of return is 4.897%. When this is applied to Indiana-American's fair value rate base of \$1,051,885,770, the result is a net operating income of \$51,509,986.

9. Operating Results Under Present Rates.

A. Revenues. Petitioner's proposed pro forma annual revenues at present rates on June 30, 2011, totaled \$194,244,778. The OUCC's proposed pro forma revenues at present rates equaled \$197,722,414. The OUCC accepted Petitioner's proposed adjustments for Bill Analysis Reconciliation, Unbilled Revenue, DSIC Normalization, and Normalization of the 43680 Rate Increase. Petitioner accepted on rebuttal a portion of the OUCC's proposed adjustments for test-year customer growth and late fee revenues. The remaining differences as well as issues raised by other parties are discussed below.

(1) Test-Year Customer Growth Normalization.

(a) Petitioner's Position. Petitioner proposed to normalize residential and commercial revenues to reflect changing customer counts during the test year and for the rate base update period of January 1 through June 30, 2011. Mr. VerDouw explained that these adjustments are consistent with the treatment ordered by the Commission in Cause No. 43680. He calculated the monthly increase or decrease in residential and commercial customers for each of the months from January 2010 through June 2011 using actual increases/decreases by month in customer accounts from January 2010 through December 2010, and budgeted increases/decreases in customer accounts from January through June 2011. He explained that the change in customers was calculated by month and annualized for the number of months for which the service charge was not accounted for in the test-year bill analysis. In addition, Mr. VerDouw calculated an adjustment for annualization of monthly volumetric usage for increases/decreases in test-year residential and commercial customers by month using the average test-year monthly consumption by District for a residential or small commercial customer. The calculation for service charge and volumetric adjustment was made up or down, depending on whether or not the number of residential and commercial customers went up or down over the period. Using the methodology described above and with respect to those changes in customer counts occurring during the test year, Mr. VerDouw derived an annualization adjustment that increased test-year revenues by \$54,405 for changes in residential customer counts and decreased test-year revenues by \$700,044 for changes in commercial customer counts during the test year.

(b) OUCC's Position. For those customers added during the test year, Ms. Stull used Mr. VerDouw's methodology to normalize revenues for additional customers with three changes. First, she applied the rates approved in Cause No. 42351 DCIS 6, consisting of a 3.16% increase in both the base monthly charges and the volumetric rates in calculating her test-year customer growth adjustment. Second, she used both block one rates and block two rates in calculating commercial customer growth during the test year. Finally, she used thousands of gallons rather than hundreds of cubic feet ("ccf") in her presentation of the adjustment for test-year customer growth. Based on these revisions, Ms. Stull recommended an increase in

residential revenues of \$29,043 and a decrease in commercial revenues of \$633,015.

(c) **Petitioner's Rebuttal.** In rebuttal, Mr. VerDouw disagreed with Ms. Stull's inclusion of the DSIC surcharge because it over-counts the effects of DSIC 6. He stated that his adjustment to annualize the DSIC 6 revenue requirement in Petitioner's case-in-chief was for the full amount of the revenue authorized by DSIC 6. He explained that the Commission approves an annual DSIC revenue requirement that is reconciled to ensure no more or no less than that annual revenue requirement for the approved DSIC is collected. Accordingly, if customers use less than anticipated, the under-collection will be recovered in the subsequent DSIC. If Petitioner collects more in revenues than the authorized level, then the over-collection will flow back to customers in the subsequent DSIC. He stated the proper adjustment is for the full amount of the authorized DSIC revenues and therefore Ms. Stull is incorrect in her assumption that DSIC revenue should be applied to the customer growth normalization adjustment. As a result, Mr. VerDouw's proposed adjustment remains an increase to test-year residential growth revenues of \$54,405.

Mr. VerDouw agreed with Ms. Stull's methodology regarding the application of more than one volumetric rate block to determine the dollar value of the change in commercial accounts. He re-calculated his original commercial growth volumetric adjustment for the test year following Ms. Stull's methodology, wherein he looked at the average account usage per district and determined if any of the average usage was greater or less than 20 ccf, which is the top end of the first volumetric rate block. If the average account usage per district was less than 20 ccf, he calculated the volumetric dollar adjustment by taking that average usage times the appropriate volumetric rate (Area One or Area Two tariff) for the first rate block. If the average account usage per district was more than 20 ccf, Mr. VerDouw calculated the first 20 ccf times the appropriate volumetric rate (Area One or Area Two tariff) for the first rate block, then took the remainder of the usage at the appropriate volumetric rate for the second rate block. By applying a lower volumetric rate for any average usage by district volumetric amounts over 20 ccf, Mr. VerDouw's adjustment for commercial test-year customer growth normalization changed from a proposed decrease of \$700,044 to a revised proposed decrease for commercial test-year customer growth normalization of \$414,383.

(d) **Commission Discussion and Findings.** We find that Ms. Stull's recommended additional adjustment for DSIC 6 revenues should be rejected. Petitioner has already adjusted for a full 12 months of DSIC revenues. We find that Ms. Stull's proposed adjustment to account for more than one volumetric block should be accepted, but we accept Mr. VerDouw's calculation on rebuttal. Mr. VerDouw's analysis of the impact of the rate structure was more detailed. The total combined residential and commercial growth pro forma adjustment for changes in customers added during the test year is a decrease of \$359,978.

(2) **Post-Test-Year Customer Growth.**

(a) **Petitioner's Position.** Mr. VerDouw sponsored an adjustment to normalize residential and commercial revenues to reflect changing customer counts with respect to monthly service charge billings for the rate base update period of January 1 through June 30, 2011. Mr. VerDouw stated in his direct testimony that this post-test-year adjustment to service charge revenue only is consistent with 2010 Rate Order. The total adjustment is an increase of

\$392,106 for residential and \$1,664 for commercial, for a combined total increase of \$393,770.

(b) **OUCC's Position.** Ms. Stull proposed an additional adjustment to post-test-year growth using the same methodology as her adjustment for test-year customer growth. Ms. Stull included a base-charge component, a volumetric component, and the DSIC 6 surcharge and applied the block one and block two rates in calculating commercial customer growth in the post-test-year period. Her volumetric component was based on average post-test-year consumption data provided by Petitioner in discovery. Ms. Stull's post-test-year customer growth adjustment amounted to an increase in residential revenues of \$1,013,253 and an increase in commercial revenues of \$694,552.

(c) **Petitioner's Rebuttal.** Mr. VerDouw testified that he followed the same methodology in calculating the post-test-year change in residential and commercial counts by month as Petitioner used in Cause No. 43680, which was approved in the 2010 Rate Order. Mr. VerDouw testified that although Petitioner has added more customers following the test year, it is not actually selling more water. He stated that despite having more residential and commercial customers in 2011 than in 2010, Petitioner's total water sales to residential customers in the first nine months of 2011 were below the total water sales to residential customers in the first nine months of 2010. Further, total sales volumes to all customer classes are lower in 2011 than 2010. During the first nine months of 2011, total sales are 25.495 MG compared to 26.120 MG for the first nine months of 2010, a decline of 2.4%. He stated weather cannot be the explanation for this decline, because the summer months of 2011 have been particularly hot and dry. Mr. VerDouw asserted Ms. Stull's volumetric adjustment based on customer growth is therefore not fixed, known, and measurable and should be rejected.

(d) **Commission Discussion and Findings.** The Commission has a long history of accepting a customer growth adjustment for the service charge portion of the bill because only that portion was found to be fixed, known, and measurable. *See 2010 Rate Order*, 2010 Ind. PUC LEXIS 355, at *193-194. This is especially true when there is an increase in the number of customers but a decline in total consumption. *Id.*, at *194. Here, Petitioner again reported an increase in the number of customers since the close of the test year but a decrease in sales – a decline in total sales volumes of 2.4% during the first nine months of 2011. Therefore, we conclude that Petitioner's Post-Test-year Customer Growth pro forma adjustment is \$392,106 for residential customers and \$1,664 for commercial customers, totaling \$393,770.

(3) **Late Fee Revenues.**

(a) **OUCC's Position.** Pursuant to 170 IAC 6-1-13(B)(2), Petitioner began assessing late fees to delinquent bills in February 2011. Ms. Stull proposed an adjustment to account for pro forma late fee revenues. Ms. Stull calculated late fee revenues recorded in February through July of 2011 as a percentage of total operating revenues recorded during the same period. She then averaged the percentage of late fees to total operating revenues over the six months to arrive at a rate of 0.6497% and applied this to pro forma present rate revenues to yield a pro forma late fee revenue amount of \$1,260,844.

(b) **Petitioner's Rebuttal.** On rebuttal, Mr. VerDouw agreed that an adjustment needs to be made for the addition of late payment fees, but proposed two changes to

Ms. Stull's adjustment. First, Mr. VerDouw testified that approximately \$10,000 per month of the late payment fee (\$120,000 per year) is currently being charged to two large municipal customers. Indiana-American has learned that its billing cycle did not close at a time that was conducive to these customers being able to approve the claim before the due date. Mr. VerDouw explained that Indiana-American has modified its billing cycles to fit with these customers' claims approval schedules and has waived the previously charged late payment fees. He expressed his belief that, in the future, both customers will be making payments by the due date. Accordingly, Mr. VerDouw proposed reducing Ms. Stull's adjustment by \$120,000 for those two accounts.

Second, since late payment fees are assessed only on Indiana-American's slowest paying customers, Mr. VerDouw opined that, based on his experience and a limited bad debt analysis he conducted, Indiana-American will collect far less of the late payment fees than are actually assessed – and the write-off will be far more than the uncollectible rate of 1.1772% that is currently being proposed for this case. He explained that bad debt expense is calculated as a percentage of total operating revenues. All accounts that become uncollectible and therefore drive the bad debt expense percentage will be delinquent accounts against which the late fee is assessed. As a result, the bad debt percentage would necessarily be a higher bad debt percentage when one just looks at accounts that become delinquent and subject to the late payment fee. He analyzed a snapshot to determine what percentage of accounts recoverable went from current to past due. These are accounts to which the late payment fee would apply. He then compared those accounts receivable to Petitioner's bad debt expense for the prior month, since by definition all bad debts generated the prior month would have become delinquent in this time frame. The percentage of bad debts to accounts becoming delinquent was approximately 11%, but Petitioner reduced the amount to 10% for its proposed adjustment. He proposed that Ms. Stull's late payment fee adjustment less the \$120,000 adjustment proposed above for billing cycle changes be further reduced by 10%, to account for late payment fees that are assumed to not be collected by Indiana-American. Mr. VerDouw's proposed changes to Ms. Stull's adjustment for late payment fees would reduce her adjustment by \$234,084, thus adjusting revenue by \$1,026,760 to account for late payment fees.

(c) **Commission Discussion and Findings.** In future cases, accounting for late payment revenues will be a much simpler task, since Petitioner will have a full 12 months of actual data. In this case, we must estimate as best we can the impact on Petitioner's revenues from implementing the late payment fee provided by our rules. Ms. Stull used the data available at the time of her filing (late fee revenues recorded from February through July 2011) to estimate the annual percentage of late fee revenues to total operating revenues and applied this percentage to Petitioner's pro forma present rate revenues to calculate a pro forma late fee revenue amount of \$1,260,844. Mr. VerDouw testified that Petitioner has worked with two municipal customers to address the cause of their late payments, making future late payments unlikely. We agree with Mr. VerDouw that it is appropriate to reduce Ms. Stull's pro forma late fee revenue by \$120,000.

Mr. VerDouw also proposed an adjustment to Ms. Stull's pro forma late fee revenue amount to account for the fact that Petitioner will not actually receive all late fees charged. Mr. VerDouw looked at data for the month of March, 2011, which revealed that 10.7996% of Petitioner's collectable late fees had slipped to an age of 31-60 days. As a result, Petitioner

proposed a 10% reduction to the pro forma late fee revenue adjustment to account for uncollectable late fees. As stated above, because we do not have a full year of actual data, we must estimate as best we can what the actual impact of collected late fees will be on Petitioner's revenues. Both Ms. Stull and Mr. VerDouw made estimates using limited data in an attempt to reach a reasonable pro forma late fee revenue adjustment. We accept the Parties' methodologies and Mr. VerDouw's late fee revenue adjustment. Thus, we find that Petitioner's pro forma late fee revenue adjustment is \$1,034,513.

(4) Declining Usage Adjustment.

(a) Petitioner's Position. Petitioner's Witness, Mr. Gary A. Naumick sponsored an adjustment to revenues to reflect a declining usage trend by Petitioner's residential customers over the last ten years. Petitioner's proposed declining usage adjustment is based on Mr. Naumick's analysis regarding water usage trends by Indiana-American's residential customers and shows a continuing annual decline of 769 gallons per customer per year, or approximately 2.1 gallons per customer per day ("gpcd"). This relates to an approximate annual rate of decline of 1.32% per year at present customer usage levels. Mr. Naumick testified that the decline is attributable to several key factors, including the increasing prevalence of more efficient plumbing fixtures within residential households, the conservation ethic of customers, conservation programs, and price elasticity. He explained that the Energy Policy and Conservation Act of 1992 mandated the manufacture of water efficient toilets, showerheads, and faucet fixtures and the more recent Energy Independence & Security Act of 2007 has established high efficiency standards for dishwashers and clothes washers, which will further impact indoor water usage and could perpetuate and further accelerate the downward trend. Overall, Mr. Naumick stated that with all other factors being equal, a typical residential household in a new home constructed in 2011 would use 35% less water for indoor purposes than a non-retrofitted home built prior to 1994. He also stated that as customer awareness and interest in the benefits of conserving water and energy continues to increase, customers may decide to replace a fixture or appliance even before it has broken or further reduce consumption by changing their household water use habits in other ways.

Mr. Naumick's analysis is based on monthly residential water sales recorded in January through April for each of the last ten years. He explained that studying usage in the winter months helps reveal underlying trends in indoor (or "base") usage, largely independent of discretionary usage (such as lawn and landscape irrigation, car washing, filling swimming pools, etc.). He explained that the ten-year time period was utilized for his analysis because it is long enough to adequately study the underlying trend, while also providing a reasonable reflection of the most recent trends and demographics. In order to calculate the usage per customer trend, Mr. Naumick performed a four-step calculation. First, monthly water sales data were recorded and divided by the number of customers to yield the average usage per customer. Next, winter consumption (January through April) was calculated in gallons per customer per month for the years 2001 through 2010. A "best-fit" linear regression trend line was then created using the 10 year winter usage per customer history. Finally, in order to apply the trend in "base" usage to the full-year usage by customers, Mr. Naumick calculated what portion of consumption is constant throughout the year (and therefore is considered to be baseline indoor usage) versus the amount of increased usage that occurs during the discretionary summer usage period. This was done by calculating the daily usage per customer during winter months versus the daily usage per

customer for the entire year. The results show that 92.0% of residential usage is considered base usage. The winter trend was then applied to the full-year consumption. As noted above, Mr. Naumick's analysis shows that residential usage per customer is declining at a rate of 769 gallons per customer per year, or 2.1 gallons per customer per day. Mr. VerDouw then calculated the effects of twelve months of this decline, corresponding to the adjustment period of 2011, and computed an adjustment that decreased revenues by \$861,090.

Mr. Naumick testified that the trend exhibited by Indiana-American is very similar to the trends being experienced by other American Water companies in other states and across the industry. He referred to the 2010 Water Research Foundation ("WRF") report, which indicated that many water utilities across the United States and elsewhere are experiencing declining water sales among households. The report further stated that a pervasive decline in household consumption has been determined at the national and regional levels. He testified that not only does he expect the declining usage trend to continue in the future, but could, in fact, accelerate as a result of water efficient fixtures and conservation actions by utilities, such as Indiana-American's Wise Water Use Plan.

Mr. Naumick noted that certain water efficiency initiatives being undertaken by Indiana-American impact residential water usage. He observed that currently, there is an economic disincentive to Indiana-American to sell less water in its service territories, but expressed Indiana-American's desire to work with the Commission to overcome this disincentive and fully unlock the benefits of resource preservation.

(b) OUCC's Position. Mr. Jon Dahlstrom opposed Petitioner's declining usage adjustment. Mr. Dahlstrom explained that for ratemaking purposes, Mr. VerDouw's schedule assumes a prospective decline in customer usage that translates into an \$861,090 revenue requirement. Mr. Dahlstrom specifically took issue with Mr. Naumick's failure to consider alternative causes for a decline in usage, the accuracy of the data, and whether the data actually shows a continuing downward trend in usage.

Mr. Dahlstrom noted that, while Mr. Naumick listed items that could potentially influence customer use (e.g. the introduction of water efficient appliances, housing age and stock, appliance saturation, and remodeling), during cross-examination by the OUCC, Mr. Naumick acknowledged that Indiana-American has not performed any studies as to the particular causes of any trend indicated by his study. Mr. Dahlstrom noted that Mr. Naumick based his analysis on one factor – the passage of time. He explained that, because numerous factors might cause customer use to vary, it is nearly impossible to isolate just one of these items (time) and rationally argue this one item provides fixed, known, and measurable justification and support for the proposed adjustment.

Mr. Dahlstrom explained that, to represent a period not influenced by outdoor usage, Mr. Naumick's analysis was done using one point for each winter period (January – April). Mr. Dahlstrom indicated that he analyzed the four winter months in each of the ten years and noted a large variability within each year and from year to year. He considered the large variability not indicative of base load use. Rather, Mr. Dahlstrom considered that variability to suggest the existence of many variables driving customer use each and every month within the 10 year period on which Mr. Naumick based his analysis.

Mr. Dahlstrom also expressed doubt about the accuracy of the information relied on by Mr. Naumick. Mr. Dahlstrom noted that adjustments were made to the Indiana-American sales and customer count historical data prior to Mr. Naumick running his regression analyses, but no reason for the changes was given. For example, Mr. Dahlstrom noted, during one two-year period Indiana-American added customers to the customer count in each month of the period, but there was no corresponding adjustment made to consumption during these same months. In another example, Indiana-American moved a large quantity of sales from April 2010 to May 2010. The magnitude of the move increased May 2010 sales by 35% and decreased April 2010 sales by 20%. Mr. Dahlstrom noted that because Mr. Naumick's analysis was based on January through April consumption, changes to any of these months would change the results of his analysis. Mr. Dahlstrom explained he had no opinion about the appropriateness of such a change in the data. But he did note that such a change would have the effect of decreasing the winter usage for 2010 and thereby increasing the declining use results in Mr. Naumick's analysis. Mr. Dahlstrom suggested that such a change should call into question the data inputs for prior years.

Mr. Dahlstrom expressed other concerns about the compilation of the inputs Mr. Naumick considered. Mr. Dahlstrom noted that the residential usage was based on historical data compiled by Indiana-American in due course, but added that Mr. Naumick is unable to speak to whether any changes have occurred in how Indiana-American compiles the data or verifies the accuracy of the data. Mr. Dahlstrom added that, like most water utilities, Indiana-American does not read its meters for every customer on the same day every month of every year. For example, customers in the Northwest District are scheduled to be read every other month. Thus, Mr. Dahlstrom concluded, there is nothing in Mr. Naumick's analysis to establish that each four month period in each year included the same number of days for the customers as a whole. Mr. Dahlstrom stated that Mr. Naumick's study made no allowance for the fact that from year to year there may be variations in the number of days in December included in the so called "winter" month readings. For instance, conditions in December and January may result in delayed readings in a given year that would skew the results in Mr. Naumick's methodology.

Mr. Dahlstrom noted that even a one-day difference can affect the results of the data. He explained that if a typical day's usage is 150 gallons, one fewer day of recorded usage for the average customer during the "winter" months would explain more than half of the annual decline projected by Mr. Naumick. Thus, Mr. Dahlstrom noted, a difference in two days would exceed the "trend" observed by Mr. Naumick.

Mr. Dahlstrom stated that Mr. Naumick does not appear to acknowledge any margin of error in his inputs. But the errors and variances that seem likely lead him to conclude that the trend line observed by Mr. Naumick is not a sufficiently reliable basis upon which to recommend a revenue requirement that deviates from the test year. He concluded the adjustment to revenues proposed by Mr. Naumick does not meet the fixed, known, and measurable standard.

Mr. Dahlstrom also noted that Mr. Naumick chose the four months he selected to "isolate base, non-discretionary usage." Mr. Dahlstrom did not agree that this goal was necessarily accomplished. Mr. Dahlstrom reviewed the per customer usage for those months and observed a variation among the months that was inconsistent with this theory. Mr. Dahlstrom reasoned that if such usage is truly non-discretionary, one might expect there to be less variation in average gallons used per customer from month to month, within each year. Mr. Dahlstrom stated that

this could be explained by variations of when the meters are read from month to month or reductions in usage due to vacationing. Mr. Dahlstrom added that neither of these explanations adds an element of reliability to Mr. Naumick's reliance on these winter months.

Mr. Dahlstrom added that Mr. Naumick's decision to ignore the usage per customer for the entire year does not give a full picture of what is happening to residential use and may skew any results. For instance, Mr. Naumick's analysis, which looks only at the four "winter" months, indicates a decline in per customer use from 2009 to 2010. But looking at the year in its entirety, per customer use increased from 2009 to 2010. Mr. Dahlstrom noted that, while Mr. Naumick's analysis is designed to address a particular trend and is not designed to capture changes in non-discretionary use, its application may lead to customers paying more in rates to address declining usage when usage on a per customer basis may in fact be increasing.

Mr. Dahlstrom added that the theory behind Indiana-American's adjustment to test-year operating revenues is to allow it to meet its revenue requirement by offsetting the decline it projects in its revenues. Therefore, he questions Indiana-American's decision to justify the revenue adjustment by looking only at sales on a per customer basis, and not overall residential sales for Indiana-American. Mr. Dahlstrom asserted this selected methodology fails to take into account Indiana-American's sales growth from the addition of new customers, which would offset a decline in per customer usage. For instance, Indiana-American added 2,544 customers in the first 6 months of 2011. If you multiply this by an average monthly consumption for 2011 and then multiply this amount by 12 months, you arrive at usage of approximately 135 million gallons in additional sales for the first 6 months of 2011 due to new customer growth. Mr. Dahlstrom added that an annualized amount of customer growth would yield much larger results. Mr. Dahlstrom stated that if there were declining use losses in 2011, this sales growth would offset those estimated losses.

Considering the calculations Indiana-American made to arrive at the baseload percentage, Mr. Dahlstrom said the calculation can also be affected by the period of time chosen. He noted Mr. Naumick chose to look at a period of ten years in his analysis. However, a shorter period, such as five years, yields results that may be more representative of current conditions. Mr. Dahlstrom explained that the AWWA's M1 manual recommends the most recent 5-year period for calculating Capacity Factors. Using this same 5-year period in calculating a baseload factor is consistent in this case. Results for the individual years on Petitioner's Exhibit GAN-3 vary widely from 86% to 96% adding to the concern that this average is not representative of today's conditions.

Mr. Dahlstrom expressed other concerns with the 92% baseload factor chosen. Mr. Dahlstrom explained that after running his 10-year regression analysis on baseload data, Mr. Naumick, calculated a 708 gallon annual trend decrease in baseload usage, Mr. Naumick then divided this trend result by 92%, and mistakenly increased the annual trend amount to 769 gallons. Mr. Naumick's analysis calculated the impacts on his winter baseload amount over time. Dividing his results by 92% mistakenly applies his declining baseload result to non-baseload demand (the 8% discretionary demand above 92% baseload). There is no need to divide the results by 92% because Mr. Naumick is only addressing winter baseload sales, not annual total sales in his analysis. This mistaken overstating of the results is another concern Mr. Dahlstrom expressed in his testimony.

Mr. Dahlstrom addressed the likelihood of the trend Mr. Naumick described continuing into the next decade. He said that it is possible that extending Mr. Naumick's data points into the next ten years may reflect what will happen, but it also may not. Mr. Dahlstrom stated that is one of the problems of basing revenues on a projected, unknown amount. Mr. Dahlstrom said that the important question is whether it is sufficiently certain that we will see the level of usage projected by Mr. Naumick during the life of the rates established in this rate case, which is approximately two years.

Mr. Dahlstrom noted that Indiana-American ran more than one analysis for its adjustment and the different studies had widely varying results. Mr. Dahlstrom explained that Indiana-American ran two different analyses on the January-April winter baseload data, one for ten years and one for five years. The result of the 10-year analysis was a projected annual trend decrease of 769 gallons. The result of the 5-year analysis was a projected annual trend decrease of only 244 gallons. He noted that Mr. Naumick testified on the witness stand that he had added the January-June 2011 data to his original analysis and he again came up with different results. Mr. Dahlstrom explained these substantially differing results support his position that the decline in usage for the next two years as predicted by Petitioner is too speculative.

Mr. Dahlstrom attached to his testimony copies of Mr. Naumick's 5-year and 10-year graphs and noted that they show a visible change in the slope of the line between the 10-year graph and the 5-year graph. Mr. Dahlstrom added that this suggests a leveling off of the rate of decline over the last ten years. Mr. Dahlstrom also noted the substantial difference in slope between the 5- and 10-year regression formulas shown on Mr. Naumick's spreadsheet, which Mr. Naumick provided in response to OUCC Data Request No. 01-007. Mr. Dahlstrom considered this too to support the leveling off in the rate of decline.

To explain the leveling off, Mr. Dahlstrom ran linear regression analyses for first 5-year and second 5-year periods used in Mr. Naumick's analyses. He explained that a comparison of these results indicates the declines in customer use had been more pronounced in the past, but those declines have now leveled off and will continue to level off when compared to Mr. Naumick's results. In addition, to more thoroughly investigate these inconsistencies, Mr. Dahlstrom ran a non-linear regression analysis of Mr. Naumick's winter month data over the same 10-year period. Mr. Dahlstrom's non-linear regression analysis shows this same trend of declining use leveling off in the most recent years.

Mr. Dahlstrom explained that, while Mr. Naumick's regression analysis calculated a decline of 769 gallons per year, the ten years included in Mr. Naumick's study did not consistently show actual decreases from year to year. Mr. Dahlstrom noted that looking at the months relied on by Mr. Naumick in his analysis, three of the nine year to year comparisons show an increase in per customer baseload use. Moreover, two of the last four comparisons of baseload use showed increases from year to year. Mr. Dahlstrom said this shows that the correlation in Mr. Naumick's analysis is not strong and impugns the study's ability to project a decrease or increase in the relatively short period between rate cases. Mr. Dahlstrom also noted Indiana-American will have the opportunity to adjust to any changes in per customer use in each rate case it files.

In addition, Mr. Dahlstrom also noted Mr. Naumick did not take into account potential growth in sales to Indiana-American's commercial, industrial, and sale-for-resale customers, which may offset the decline in residential use. Mr. Dahlstrom noted that a Value Line article on American Water, published July 22, 2011, stated that declines in residential water usage should slow and we look for more growth of the company's commercial and industrial water segments. Mr. Dahlstrom added that an article by Mary Ann Dickerson, President and CEO of the Alliance for Water Efficiency, published in Water Efficiency magazine indicated that water use is going down in the residential sector indoors, but going up outdoors.

Mr. Dahlstrom indicated these articles underscore the many challenges analysts face when trying to forecast what will happen to water use in the future. Considering this issue to be complex, he added that we cannot simply look at one aspect in isolation, as Mr. Naumick did in his study. Mr. Dahlstrom suggested that before the Commission establishes expectations of water utilities receiving increases in their revenue requirements, these complexities need to be better understood and more certainty established.

Based on the foregoing, Mr. Dahlstrom recommended the Commission not allow Petitioner's proposed \$861,090 revenue adjustment.

(c) **West Lafayette's Position.** West Lafayette Witness, Mr. Otto W. Krohn also opposed Petitioner's declining usage adjustment on the basis that Mr. Naumick's analysis lacks sophistication and is unsuitable for ratemaking purposes. Mr. Krohn contended that Mr. Naumick's analysis lacked thoroughness in that it did not include a "t-test" to test the statistical significance of the slope of the regression equation or an "f-test" to test the statistical significance of the regression equation as a whole. He further stated that Mr. Naumick's regression equations are time-series regressions that do not capture cyclical or counter-cyclical trends, the effects of changes in direction of the data, or changes in the rate of change over time. As such, Mr. Krohn asserted that these regressions must be tested for possible non-linear trends and for autocorrelation and that it is unclear whether these tests were performed. Mr. Krohn testified that the R^2 value for the regression equation estimating Mr. Naumick's 10-year trendline is low and does not demonstrate a direct correlation between water usage and time. He also suggested that Mr. Naumick's analysis is oversimplified because it does not specifically address changes in weather, income, general economic conditions, employment status, household composition, and community demographics as factors potentially affecting residential customer water usage. Finally, Mr. Krohn stated Petitioner has not offered sufficient information to establish that average monthly water usage by its residential customers will not level off or even increase in the next several years.

(d) **Crown Point's Position.** Mr. Guerrettaz also opposed Petitioner's declining usage adjustment. First, he testified that the declining residential use adjustment is not justified or necessary because Petitioner already files a base rate case approximately every two years and receives DSIC rate adjustments on a regular, ongoing basis. He explained that, in traditional Indiana regulation, increases and decreases in operating revenues are captured with each rate case. Given that Petitioner files a base rate case every two years, plans to continue doing so, and receives regular and ongoing DSIC adjustments, Mr. Guerrettaz stated that regulatory lag is already minimized and he sees no need to impose this pro forma adjustment in rates for a hypothetical estimate of what decline in residential sales may or may not occur.

Second, Mr. Guerrettaz pointed out that the proposed adjustment focuses only on possible residential sales decreases. It does not address other customer class sales and revenue to the Petitioner, which he testified may offset any decrease in residential sales. Similarly, he testified that Mr. Naumick's analysis does not take into account the impact of weather on water sales, particularly during the summer months. He testified that Mr. Naumick's Exhibit GAN-3 shows there have been periods where increased summer usage more than offset any perceived decline in residential usage. He testified that increases in customer base between rate cases can also offset any perceived decline in residential sales.

Third, Mr. Guerrettaz testified that it is not reasonable for customers, who voluntarily engage in water conservation or pay for more efficient plumbing fixtures and appliances, to have the savings they expected to enjoy reduced or eliminated by a declining usage adjustment. He pointed out that the customer utility bill savings to be achieved by high efficiency appliances is one of the reasons people choose to buy high efficiency appliances and to install low flow fixtures. Mr. Guerrattaz opined that the declining usage adjustment could discourage people from voluntary conservation and purchasing efficient appliances.

Fourth, Mr. Guerrettaz testified that Petitioner's declining usage adjustment is not fixed, known, and measurable. He testified that it is not fixed that the estimated decline in sales will occur in the twelve months following the test year. He testified the projected reduction is not known, with certainty, to occur. He testified that the projected reduction is not reasonably measurable or subject to accurate quantification for ratemaking purposes. He testified "Mr. Naumick can't accurately predict floods, droughts, or economic changes, and thus, cannot now accurately measure the direct impact of each on future sales levels. In addition, he testified there is no showing of dire need or unusual circumstances that warrant the proposed non-traditional accelerated recovery of possible future sales declines that otherwise would be reflected in the revenue update in Petitioner's next biennial rate case.

Finally, Mr. Guerrettaz testified that Petitioner is uncertain of the number of days in its billing data. He took issue with the number of billing days utilized by Mr. Naumick in his analysis. He characterized the data used in Mr. Naumick's analysis as inaccurate and questioned the reliability of the analysis as a result.

(e) **Petitioner's Rebuttal.** Petitioner's Witness, Mr. VerDouw, explained that the declining usage adjustment is fixed, known, and measurable and is not a "projection" as suggested by Mr. Dahlstrom. He stated that Mr. Naumick used ten years of historical residential usage data to develop a relationship between residential customer usage and time to produce an adjustment to Test-year residential customer water usage based on a fixed, known, and measurable historical ten-year trend. He compared this adjustment to an adjustment to test-year expenses for known and measurable increases in Purchased Power expenses. He explained that the fact that Mr. Naumick's adjustment is calculated using statistical modeling, whereas a Purchased Power Expense adjustment is made using a revised rate tariff and spreadsheet, is immaterial to the concept that both are fixed, known, and measurable adjustments for known changes to test-year conditions. He asserted that Mr. Dahlstrom's categorization of Mr. Naumick's analysis and proposed adjustment as a "projection" is incorrect and should be rejected.

Mr. VerDouw explained that the purpose of the adjustment was to account for the continued decline during the adjustment period, the twelve months of 2011. During the first nine months of 2011, the decline estimated by Mr. Naumick has manifested itself at a more dramatic rate. Monthly sales per customer for all customers have decreased by 1.5%, and for residential customers (the class for which the adjustment is made) the decline is 2.1%. On a total sales volume basis, 2011 year-to-date sales volumes are down 2.4% over the test year. Mr. VerDouw explained that 2011 has been hot and dry across all operations and so weather is not the cause of the decline.

In response to Mr. Dahlstrom's and Mr. Krohn's criticisms of his analysis for failure to consider other factors that may influence the declining residential usage trend, Mr. Naumick explained that his time series analysis recognizes that multiple factors are influencing the trend, and that these factors are occurring over time. He explained that rather than selectively including or excluding specific factors that may be impacting residential customer base usage, his analysis quantifies the composite effect that all relevant factors are having over time. He explained that in his linear regression analysis, time, as the dependent variable, functions as a proxy for price, fixture efficiency, income, employment, conservation ethic, and a host of other factors that impact the per customer usage of water over time. Mr. Naumick pointed out that none of the intervenors specifically addressed the drivers that are exerting strong downward pressure on residential usage per customer. Instead, the intervenors debated statistical methodology, took issue with small movements in the data within the context of an overwhelming downward trend, and expressed denial that the trend is continuing in the face of both the historical trend and the presence of continuing drivers toward conservation behavior. They raised arguments regarding growth and weather, which are irrelevant to the "base usage per customer" analysis Mr. Naumick presented. Mr. Naumick observed that the intervenors simply argue that the decline in residential customer usage will stop, or should be ignored, but fail to offer any information about any of the factors causing the decline, such as high efficiency fixtures and appliances or the regulatory standards on which these originate. Mr. Naumick testified that the intervenors' arguments not only contradict historical results that have been occurring for more than a decade and are anticipated to continue by most industry experts, but they would deny the residents of Indiana the opportunity to share in the benefits that a progressive regulatory approach to water and energy efficiency would present.

Mr. Naumick testified that he has a high confidence level that the replacement of older fixtures and appliances will continue to reduce residential usage per customer. He examined data provided in the U.S. Census Bureau's 2005- 2009 American Community Survey reflecting the age of the housing stock in the communities served by Indiana-American. He performed a quantitative analysis of the theoretical indoor usage in a fully conserving home. At full saturation of water efficient fixtures and appliances, indoor usage is estimated to be reduced to 95 gpcd compared to base usage by Indiana-American residential customers of 139 gpcd in 2011. This analysis projects that indoor usage by Indiana-American residential customers may continue to decline over time by an additional 32%, or 44 gpcd until full saturation with water efficient fixtures is reached. How long it will take for Indiana-American's customers to reach this theoretical threshold is dependent on numerous economic, demographic, and price factors that will impact the conversion rates over time. He analyzed the base usage of Indiana-American residential customers versus those in other states served by American Water, which showed that base usage by Pennsylvania-American customers is 8% lower (and still declining) and base

usage by West Virginia-American customers is 18% lower (and still declining) when compared to usage exhibited by Indiana-American customers. Mr. Naumick asserted that this trend further illustrates that there is ample opportunity for the customers of Indiana-American to continue to reduce usage. In addition, Mr. Naumick testified that the active measures taken by the Company to promote wise water use as it implements its Statewide Wise Water Use Plan approved in Cause No. 43649 will be complementary to the trend already occurring, and will serve to accelerate reductions in usage per customer.

In response to Mr. Krohn's criticism that his analysis lacked thoroughness and sophistication, Mr. Naumick pointed to the overwhelming results of his analysis, which focused on the historical per customer usage trend over a group of time periods considering a broad range of customers. He provided data showing the winter consumption trend for periods ranging from the last 9 years to the most recent 2 years. In each period, base residential usage per customer shows a downward trend. In addition, Mr. Naumick referred to studies of residential usage trends for the American Water residential customers in 17 states, all of which showed declines in base residential usage.

In response to Mr. Dahlstrom's suggestion that any increase in the rate of declining usage is unfounded speculation, Mr. Naumick testified that the Energy Independence and Security Act of 2007 (which impacts the water efficiency of dishwashers and washing machines, effective in 2010 and 2011, respectively), the EPA's WaterSense program (which contains specifications for many plumbing fixtures and appliances that are even more efficient than those called for in the Energy Policy Act), and implementation of Petitioner's Statewide Wise Water Use Plan all may accelerate the usage decline further. Year-to-date sales data for 2011 presented by Mr. VerDouw in Petitioner's Exhibit GMV-9R reflects a more rapid decline in usage per residential customer than predicted by the analysis in Mr. Naumick's direct testimony.

In response to Mr. Krohn's criticisms of his analysis for not including the "t-test" and "f-test" and for failing to capture cyclical and counter-cyclical trends, Mr. Naumick opined that a more sophisticated statistical analysis does not necessarily lead to a better conclusion regarding customer usage trends. He defended his analysis as technically sound and effective at showing the magnitude of the trend that is occurring.

With respect to the R^2 result of his linear regression, Mr. Naumick defended the R^2 value of 0.63 as having a moderately strong explanatory value. According to Mr. Naumick, this indicates that, over the span of ten years, time has proven to be a good predictor of the trend in declining base usage. He noted that although using a historical period shorter than ten years would have increased the statistical R^2 , this would give more weight to individual data points, including any anomalous data point. He defended his choice of a ten-year historical period and the winter months as representing the best balance of sample size, completeness, quality of historical data and relevance of historical period to contemporary demographics.

Mr. Naumick stated that Mr. Dahlstrom's five-year regression results underscore the need to examine the entire ten-year period. He stated that he conducted numerous analytical iterations before finalizing the ten-year analysis presented in his direct testimony. Using his professional experience and judgment, Mr. Naumick chose the historical period of study that provided the most logical and defensible result, regardless of whether that outcome would be favorable or not.

He explained that the 5-year trend results shown by Mr. Dahlstrom yield an average decline of -244 gallons per customer per year (gpcy) or -0.42%, whereas if a 4 year history were chosen, the result would be -931 gpcy, or -1.62%. Accordingly, Mr. Dahlstrom's 5-year analysis, which has fewer data points than Mr. Naumick's analysis, is more indicative of a bump in the data than a change in the trend. In addition, Mr. Naumick pointed out that all three regressions plotted by Mr. Dahlstrom on OUCC Exhibit JCD, Attachment 6 plainly show a strong downward trend. Mr. Naumick suggested Mr. Dahlstrom's own analysis contradicts his recommendation and supports Petitioner's position for a declining usage adjustment.

Mr. Naumick then responded to arguments related to the customer and sales data used in his analysis. He reiterated that his analysis indicates that an ongoing long-term trend is underway. He explained that field data is never perfect, and customer behaviors do not proceed in a perfectly linear fashion from year to year. Nevertheless, Mr. Naumick testified that individual customer data is of sufficient reliability and quality to render the intervenors' concerns inconsequential in the context of the long-term, broad-based evidence of declining usage that he presented. Mr. Naumick stated the four-month period studied each year is sufficiently long to minimize the impact of any potential variation in the meter reading cycle. Similarly, he stated the ten-year period analyzed minimizes the impact of a single year's data on the modeling results.

Mr. Naumick testified that Mr. Dahlstrom's and Mr. Guerrettaz's arguments that the declining usage adjustment analysis did not address consumption by other customer classes are irrelevant. He then responded to the objection of Messrs. Krohn and Guerrettaz to his analysis on the basis that weather can impact usage in a given year. He explained that his analysis takes a "weather neutral" approach through the study of usage in the winter months of January through April when customer usage is not influenced by outdoor weather. He stated that the intervenors' objection either signifies a misunderstanding of the underlying trend, or an attempt to simply cloud the issue. With respect to the objection by Messrs. Dahlstrom and Krohn that his analysis did not take into consideration customer growth, Mr. Naumick responded that his analysis is based on annual usage per customer and customer growth per se does not and will not impact usage per customer or those usage behaviors that impact usage per customer and hence Messrs. Dahlstrom's and Krohn's arguments are baseless.

Finally, Mr. Naumick responded to Mr. Dahlstrom's reference to two articles in support of the position that declining use has leveled off over the last five years. Mr. Naumick pointed out that the article in the September/October 2011 issue of Water Efficiency magazine from which Mr. Dahlstrom quoted actually supports, in numerous places, Indiana-American's position that new technologies will enable more efficient use of water for everyday customer uses, thereby continuing to lower residential usage per customer. Mr. Naumick observed that this article is one of many examples of the increasing momentum for declining water use and energy conservation. He reiterated Indiana-American's desire to partner with the Commission to seize the opportunity to enhance the economic, environmental, and energy reduction benefits that reduced water usage can bring. Mr. Naumick dismissed the Value Line article cited by Mr. Dahlstrom as irrelevant and not substantiated.

Petitioner also offered the rebuttal testimony of Mr. Kerry A. Heid to support the policy basis for the proposed declining usage adjustment. Specifically, Mr. Heid discussed the need to

eliminate regulatory or financial bias against conservation, energy efficiency, and demand side management programs (collectively “conservation programs”) and how Indiana-American’s proposed declining usage adjustment supports that policy.

Mr. Heid explained that the water utility’s costs are primarily fixed while its revenues are based to a large extent on sales. He testified that approximately 96% of Indiana-American’s costs are fixed while only approximately 4% of Indiana-American’s costs vary based on customer usage/utility production. Mr. Heid stated that under Indiana-American’s present rate structure approximately 37% of Indiana-American’s revenues are fixed (including fire protection and miscellaneous revenues), and approximately 63% of Indiana-American’s revenues are variable. Mr. Heid explained that traditional utility ratemaking creates a paradigm where a utility’s revenues, and therefore its ability to recover its costs, are directly dependent on customers’ water usage. Unfortunately, he stated, because this rate design couples customer consumption with cost recovery, it is financially disadvantageous for a water utility to encourage its customers to use less water. Mr. Heid testified that innovative regulation and ratemaking is required to allow the water utility to advocate the benefits of conservation without sacrificing its own ability to recover its operating and capital costs.

Mr. Heid described Petitioner’s current conservation program, its “Statewide Wise Water Use Plan” approved on August 26, 2009 in Cause No. 43649. This Plan was the first conservation plan approved by the Commission. Indiana-American requested approval to defer and eventually recover program costs related to the development and implementation of its Wise Water Use Plan. Indiana-American is not recovering lost revenues or an incentive for its conservation program. Mr. Heid explained that an incentive for a conservation program such as Petitioner’s is needed because utilities have a natural disinclination to encourage a reduction in sales and utilities’ profits are a function of their supply-side investments and their ability to earn a return on those rate base assets. Therefore, according to Mr. Heid, utilities need to be made whole for those lost opportunity returns that result from the use of demand-side rather than supply-side resources.

Mr. Heid stated one option for regulators to help remove the financial disincentive related to lost sales is to decouple profits from sales. He noted the Commission has used this approach successfully in a number of gas companies. Another approach described by Mr. Heid is a Lost Revenue Adjustment Mechanism (“LRAM”). Under this approach utility revenue losses associated with approved conservation measures are estimated or measured and the utility is allowed to recover the revenues from customers. Mr. Heid noted that the LRAM is most effective with electric utilities whose energy efficiency programs are more suitable for precise estimation or measurement. He explained Indiana has a Demand Side Management rule that provides electric utilities the opportunity to request lost revenues. The final alternative Mr. Heid mentioned is the demand-repression adjustment, which recognizes the effects of declining usage. Indiana-American’s declining usage adjustment is such an adjustment. Mr. Heid noted that there are a number of other approaches and many variations of such approaches, such as straight fixed variable rate design, future test years, and regulatory incentives.

Mr. Heid testified that Indiana-American’s proposed declining use per customer adjustment is a very modest mechanism to help remove some of the disincentives. He stated that the Company is not asking for full decoupling at this time, nor has it proposed anything

approaching a straight fixed variable rate design. It has rather asked that one year's decline in residential sales, corresponding to the adjustment period, be reflected in the calculation of pro forma revenues.

Mr. Heid then cited the National Energy Policy Act of 1992, which urged state utility regulatory commissions to establish such regulation:

The rates charged by any State regulated gas utility shall be such that the utility's prudent investment in, and expenditures for, energy conservation and load shifting programs and for other demand-side management measures which are consistent with the findings and purpose of the Energy Policy Act of 1992 are at least as profitable (taking into account the income lost due to reduced sales resulting from such programs) as prudent investments in, and expenditures for, the acquisition or construction of supplies and facilities.

15 U.S.C. §3203(b)(4).

He went on to quote NARUC's Resolution on Gas and Electric Energy Efficiency, adopted in July 14, 2004, which referred to the Joint Statement of the American Gas Association, the National Resources Defense Council, and the American Council for an Energy-Efficient Economy stating:

WHEREAS, the National Resources Defense Council (NRDC), the American Gas Association (AGA) and the ACEEE have recently adopted a Joint Statement noting that traditional rate structures often act as disincentives for natural gas utilities to aggressively encourage their customers to use less gas. Therefore, the NRDC, AGA, and the ACEEE have urged public utility commissions to align the interests of consumers, utility shareholders, and society as a whole by encouraging conservation. Among the mechanisms supported by these groups are the use of automatic rate true-ups to ensure that a utility's opportunity to recover authorized fixed costs is not held hostage to fluctuations in retail gas sales

NARUC's Resolution encouraged State Commissions to address regulatory incentives associated with sponsoring efficiency programs and to consider the regulatory recommendations set forth in the Joint Statement.

Mr. Heid testified that Petitioner's proposal is also supported by an August 2, 2006 NARUC Resolution which supports the EPA's National Action Plan on Energy Efficiency including "[modifying] policies to align utility incentives with the delivery of cost-effective energy efficiency and modify[ing] ratemaking practices to promote energy efficiency investments"

Finally, Mr. Heid noted that the State of Indiana has also encouraged removing financial disincentives for promoting energy efficiency in its 2006 report entitled "Economic Growth from Hoosier Homegrown Energy-Indiana's Strategic Energy Plan," under the heading "What We Need to Do Now." Mr. Heid testified that The Hoosier Homegrown Energy strategic plan includes the following action item on page 14: "Support alternative pricing regulatory mechanisms that encourage utilities to promote efficiency and conservation by their customers

without incurring negative financial results.” He pointed out that a second action item under the same heading states: “Support the National Action Plan for Energy Efficiency through gas and electric utilities, regulators and industry partners to create a sustainable, aggressive U.S. commitment to energy efficiency.” Mr. Heid noted that one of the National Action Plan for Energy Efficiency recommendations states: “Modify policies to align utility incentives with the delivery of cost-effective energy efficiency and modify ratemaking practices to promote energy efficiency investments.”

Mr. Heid further described the requirements placed on the Commission under the Energy Independence and Security Act of 2007 (“EISA”) as recognized by the Commission in *Commission’s Investigation, Pursuant to IC § 8-1-2-58, into the Effectiveness of Demand Side Management (“DSM”) Programs*:

The Commission further recognizes that additional issues are to be examined under the provisions of the recently enacted Energy Independence and Security Act of 2007. This Act, which amended the Public Utility Regulatory Policies Act of 1978 (“PURPA”) (as amended by Section 1252 of the EPAct05), added two new PURPA standards. These standards, reflected under PURPA section 111(d)(16) and (17), address: (16) Integrated Resource Planning and (17) Rate Design Modifications to Promote Energy Efficiency Investments and state as follows:

(16) INTEGRATED RESOURCE PLANNING.--Each electric utility shall--

- (A) integrate energy efficiency resources into utility, State, and regional plans; and
- (B) adopt policies establishing cost-effective energy efficiency as a priority resource.

(17) RATE DESIGN MODIFICATIONS TO PROMOTE ENERGY EFFICIENCY INVESTMENTS.--

- (A) IN GENERAL.--The rates allowed to be charged by any electric utility shall--
 - (i) align utility incentives with the delivery of cost-effective energy efficiency; and
 - (ii) promote energy efficiency investments.
- (B) POLICY OPTIONS.--In complying with subparagraph (A), each State regulatory authority and each nonregulated utility shall consider--
 - (i) removing the throughput incentive and other regulatory and management disincentives to energy efficiency;
 - (ii) providing utility incentives for the successful management of energy efficiency programs;
 - (iii) including the impact on adoption of energy efficiency as 1 of the goals of retail rate design, recognizing that energy efficiency must be balanced with other objectives;

- (iv) adopting rate designs that encourage energy efficiency for each customer class;
- (v) allowing timely recovery of energy efficiency-related costs; and
- (vi) offering home energy audits, offering demand response programs, publicizing the financial and environmental benefits associated with making home energy efficiency improvements, and educating homeowners about all existing Federal and State incentives, including the availability of low-cost loans, that make energy efficiency improvements more affordable.

Cause No. 42693, 2008 Ind. PUC LEXIS 190, at *80-82 (IURC Apr. 23, 2008).

Mr. Heid concluded that there is widespread support among utilities, regulators, legislators, and environmental advocates for removing financial or regulatory bias that discourages the promotion of energy efficiency. He advocated that the same should be true for water utilities. He asserted it is important for the Commission to provide timely cost recovery for declining use per customer to support the objective of increasing water conservation in Indiana.

(f) **Commission Discussion and Findings.** Petitioner asks us to authorize an operating revenue adjustment of \$861,090 to reflect a decline in per customer residential usage. The decline in usage asserted by Petitioner is based on an analysis performed by Mr. Naumick, looking at residential use in January through April of 2001 through 2010. Mr. Naumick's analysis shows that for those periods, the typical residential customer's usage has declined by an average of 769 gallons per year. Indiana-American argues that this downward trend is likely to continue going forward. The evidence in this case demonstrates a general downward trend in residential customer usage. However, Indiana-American has traditionally come to the Commission with a new base rate case every two years and anticipates continuing to do so in the future.

While Petitioner's evidence may suggest a historical downward trend in residential customer usage, we do not agree that such a trend is sufficiently predictive of future usage to meet the fixed, known, and measurable standard. In our discussion of revenues from post-test-year customer growth above, we reached a similar conclusion. We agreed with Petitioner that average usage per customer could not be used to predict a volumetric revenue adjustment for future usage. We find that same to be true for future decreased usage.

In addition, Petitioner's request relies solely on the argument that its total revenues will decline based on a decline in per customer usage. Petitioner's analysis does not take into account other sources of additional revenues that might offset the decline, for example, growth in the number of residential customers, increased usage due to weather, and the possibility of increased usage by other customer classes. Further, because Petitioner has traditionally filed base rate cases every two years and anticipates continuing to do the same, any change in actual usage from rate case to rate case is captured on a regular basis and reflected in Petitioner's base rates.

Therefore, we conclude that Petitioner's declining usage adjustment does not meet the fixed, known, and measurable standard, and should not be included as a pro forma operating revenue adjustment. The sum of all the preceding revenue test-year adjustments totals \$14,724,664, which results in a pro forma present rate operating revenue of \$196,426,042.

B. Operating Expenses. The Company proposed in its case-in-chief a total pro forma Operating Expense of \$147,232,818. The OUCC proposed a total Operating Expense of \$145,124,782. The OUCC accepted Petitioner's proposed expense levels for purchased water expense, pension and post-retirement benefits other than pensions ("OPEB") expense, Insurance Other Than Group Expense, maintenance expense, rate case expense, depreciation expense, amortization expense, and Petitioner's proposed adjustment in calculating the IDEM Safe Drinking Fee. On rebuttal, Petitioner accepted the OUCC's pro forma adjustment for Security Expense and its methodology for pro forma IURC Fee expense. Petitioner further noted that its rate case expense estimate was likely understated due to the need to call an additional rebuttal witness and the breadth of discovery in this case. We now proceed to address the remaining contested issues, as well as issues raised by other parties.

(1) Labor Expense. Petitioner proposed a pro forma adjustment to labor expense in excess of test-year labor expenses, resulting in total pro forma labor expense of \$18,151,438. The first component of the adjustment was for normalization of raises that took place during the test-year or adjustment period, which no party opposed. The remainder of the adjustment falls into three basic categories – O&M labor positions, incentive pay, and overtime, all of which the OUCC opposed. These adjustments also impact other adjustments for 401(k) expense, the defined contribution plan ("DCP"), group insurance, and payroll related taxes.

(a) O&M Labor Positions.

(i) Petitioner's Position. Petitioner's Witness Mr. VerDouw calculated a pro forma labor expense based on a level of 370 full-time associates and ten temporary, summer-help associates. Mr. VerDouw stated that of the 370 full-time associates included in the total, nine of these associates were Service Company associates for a part or all of the actual test year. Four have since transferred to Indiana-American as full-time, Indiana-American employees. And five were shifted to the Indiana-American payroll for adjustment purposes. Mr. VerDouw explained that those five associates are classified as Service Company employees to allow them to charge time for non-Indiana-American work to other American Water affiliates; however, the time charged to those affiliates is miniscule. As such, Mr. VerDouw testified, they are essentially full-time, Indiana-American employees and are reflected as such in this case. He stated that an offsetting adjustment was made to Support Services Expense for these employees. If an associate was hired during the test year, his or her hours were adjusted to reflect a full year of employment. Likewise, if an associate left during the test year, Mr. VerDouw stated that those hours were eliminated. Finally, Mr. VerDouw testified that any current vacancies were adjusted to reflect the normal level of regular and overtime hours for each specific classification.

(ii) OUCC's Position. Mr. Patrick disagreed with Petitioner's proposed pro forma labor expense. Mr. Patrick testified that in order to calculate pro forma labor expense, he reduced Petitioner's pro forma full-time employee count by twelve and Petitioner's

temporary employee count by one. Mr. Patrick explained that the 370 full-time employees consisted of 345 filled positions and 25 vacant positions. As of June 30, 2011, he calculated that three of the 345 positions were unfilled, leaving a balance of 342. He further stated that as of June 30, 2011, nine of the 25 vacant full-time positions were filled internally or never filled, leaving a balance of 16 employees. In addition, Mr. Patrick testified that as of June 30, 2011, one of the temporary positions was not filled. As a result, Mr. Patrick removed the O&M expense for the three additional vacant positions as of June 30, 2011, the nine internally filled or never filled full-time positions, and the one unfilled temporary position from Petitioner's pro forma expense adjustment. His proposed pro forma O&M labor expense was based on 358 full-time and 9 temporary employees. His adjustment carried through to his proposed level of overtime expense, employee benefits, and payroll tax.

Mr. Patrick also expressed concern with the monthly count of full-time, Indiana-American employees from January 2008 through June 2011. He asserted that Petitioner's number of actual employees never exceeded 356 during the period from January 2008 through June 30, 2011. He argued that Petitioner's proposed full-time employee count of 370 employees is inconsistent with Indiana-American's full-time employee history. The OUCC proposed a total pro forma O&M labor expense of \$15,576,920.

(iii) **Petitioner's Rebuttal.** On rebuttal, Mr. VerDouw accepted Mr. Patrick's reduction in head count with respect to the one temporary employee, but did not agree with Mr. Patrick's proposed elimination of the 12 full-time positions. Mr. VerDouw explained that of the three positions on Attachment CEP-9 that Mr. Patrick lists as "never filled," two are currently filled and it is the Company's intent to fill the third position as quickly as possible. Of the nine additional positions Mr. Patrick claimed were vacant as of June 30, 2011, Mr. VerDouw pointed out that Attachment CEP-9 lists three of the positions as "filled internally" thus indicating the positions have been filled and should not be excluded from Petitioner's pro forma headcount. Of the remaining six positions, Mr. VerDouw stated four have been filled and the Company intends to fill the other two positions as quickly as possible. Mr. VerDouw further noted that none of the positions Mr. Patrick seeks to exclude are new positions and all have been on the Company's organization chart for some time. Mr. VerDouw recommended that Petitioner's proposed pro forma O&M labor expense be reduced only by \$7,209, reflecting the elimination of one temporary employee. Therefore, he proposed a pro forma O&M Labor Expense of \$16,122,003, which is based on 370 full-time and nine temporary employees.

Mr. VerDouw also disagreed with Mr. Patrick's assessment that the Company's actual employee levels do not reach authorized staffing levels. He explained that Mr. Patrick makes an invalid comparison between pro forma headcount and Indiana-American historical headcount, because pro forma headcount levels include at least ten positions which have been Service Company employees during all or a portion of the time frame examined by Mr. Patrick. He stated that the Company has made adjustments to its pro forma labor expense to include certain Service Company employees in Indiana-American payroll expense for rate case purposes. While these positions are included in rate cases on a pro forma basis, they are not included in the employee headcount numbers that Mr. Patrick refers to in his testimony.

(iv) **Commission Discussion and Findings.** We find that

Petitioner's labor expense should be based on 358 full-time employees, resulting in an O&M labor expense of \$15,576,920. Indiana-American had vacant full-time positions during the test year and during the pro forma period. In addition, during the Evidentiary Hearing in December, 2011, Mr. VerDouw indicated Petitioner currently had fifteen unfilled positions.

Further, as discussed below, the Commission finds that Petitioner has not adequately supported its proposal to include Business Development expense as a component of its revenue requirements. Therefore, the Commission finds Petitioner's O&M Labor Expense should be reduced by \$129,370 to eliminate the Senior Manager Business Development position. This results in a pro forma O&M Labor Expense of \$15,447,550.

(b) Incentive Pay Program.

(i) Petitioner's Position. Petitioner's total labor expense on a pro forma basis includes its annual incentive plan ("AIP") to reflect the actual AIP payout relative to 2010 performance goals for those employees that received an AIP payout in March 2011. For positions that were AIP eligible but were not in place in 2010, AIP was calculated based on each eligible employee's target percentage multiplied by the pro forma wages. Petitioner's proposed AIP pro forma expense is \$926,872. Mr. VerDouw testified that this is the same AIP program that has been approved and recovered in the past several cases.

(ii) OUCC's Position. Mr. Patrick proposed two adjustments to Petitioner's AIP expense. First, Mr. Patrick used his proposed staffing levels of 358 full-time employees to reduce Petitioner's proposed pro forma incentive pay expense by \$34,948. Second, Mr. Patrick stated that AIP rewards performance designed to enhance shareholder position, and therefore, he recommended that a significant portion of AIP should be borne by the shareholders and not the ratepayers. Mr. Patrick stated that financial success represents 70% of the AIP, while operational success represents 30% of AIP. He asserted that the focus of AIP is primarily on American Water achieving its financial goals measured by diluted earnings per share and GAAP operating cash flow. He opined that this meant the majority of AIP focuses on providing benefit directly and indirectly to the shareholders. As such, Mr. Patrick stated that shareholders should be responsible for 70% of the AIP costs and ratepayers should be responsible for 30% of the AIP costs. As a result, he recommended a further reduction to AIP expense in the amount of \$624,347 resulting in pro forma AIP expense of \$267,577.

Mr. Patrick also recommended the Commission disallow additional compensation in the amount of \$96,945 described as Long-Term Incentive Pay ("LTIP") for Petitioner's Director of Engineering, Vice President of Operations, Director of Finance, and President. He stated American Water's shareholders should pay this additional award to those employees out of corporate profits. Mr. Patrick argued that this award is driven by American Water's stock value and therefore shareholders should bear the burden of the award for the Company meeting this goal.

(iii) Petitioner's Rebuttal. Mr. VerDouw explained that the AIP is simply the portion of compensation that is "at risk" and is not paid unless the employee has actually earned it. He described Indiana-American's compensation system which targets base pay at the 50th percentile of compensation in the market for a given position. He explained

that the incentive program is designed to give employees an opportunity to receive total compensation at the 65th percentile of the market based on the additional performance elements included in the AIP performance evaluation. Mr. VerDouw testified that the AIP benefits ratepayers by helping the Company attract and retain competent personnel, reduce expenses, maintain the financial health of the Company, improve service to customers, and increase operational efficiencies. He described the three components to the Company's incentive plan: financial, operational, and individual. He stated the financial element of the incentive plan provides incentives to Company personnel related to meeting the overall financial goals of the Company, which benefits both shareholders and ratepayers. The operational and individual goals, Mr. VerDouw stated, benefit ratepayers by providing employees incentives to work to ensure that service is reliable and efficient and that customer satisfaction is high.

Mr. VerDouw noted that both Petitioner and the OUCC have recommended recovery through rates of Petitioner's AIP. According to Mr. VerDouw, the difference of opinion relates to the amount of benefits that Petitioner assumes should be allocated to shareholders on a pro forma basis. As noted above, in its Case-In-Chief, Petitioner assumed actual 2011 payout levels for those employees that received an AIP payout in March of 2011. For eligible positions that were filled after January 1, 2011, and did not receive an AIP payout in March of 2011, AIP was assumed at 100% of the position's eligibility percentage.

Mr. VerDouw disagreed with Mr. Patrick's position that a 30% payout level should apply. He testified that Mr. Patrick's position goes against prior Commission approved levels for Indiana-American and other case precedent regarding AIP payouts. He cited the Commission's Orders in *Southern Ind. Gas & Elec. Co.*, Cause No. 43839 (IURC Apr. 27, 2011) and *Northern Ind. Pub. Serv. Co.*, Cause No. 43526 (IURC Aug. 25, 2010) to support his statement that Mr. Patrick's position is inconsistent with other Commission cases involving incentive pay. He noted that the *NIPSCO* order rejected an argument very similar to Mr. Patrick's which attempted to allocate to shareholders the percentage of AIP which is driven by financial performance metrics. Mr. VerDouw testified that both of the orders cited are consistent with the Company's position in this case on AIP and that the Company's position is consistent with the determination made in the 2010 Rate Order.

Mr. VerDouw explained that in past cases, the OUCC has agreed to a level of payout for AIP equal to a three-year-average percentage payout for Indiana-American. If the OUCC had followed that same methodology in this case, Mr. VerDouw calculated that the average AIP payout percentage would have been 100.33% of target levels. However, Mr. VerDouw recommended capping the AIP payout at 100% of target eligible employee AIP, with shareholders paying any amount above the 100% target level. Mr. VerDouw testified this percentage should be applied to the Company's proposed pro forma level of staffing and not the reduced staffing level proposed by Mr. Patrick. Mr. VerDouw's rebuttal position adjustment for pro forma incentive plan expense results in a reduction to the proposed adjustment in the amount of \$189,535. With this adjustment, the Company's recommended pro forma test-year level of incentive plan expense is \$737,337.

With respect to Mr. Patrick's recommendation to eliminate \$96,945 included in the Company's labor expense for LTIP expense, Mr. VerDouw responded that the purpose of the LTIP is to give high level management positions additional incentives to remain with the

Company so that the Company and ratepayers can benefit from their experience and expertise. Accordingly, he recommended that the Company's pro forma LTIP expense of \$96,945 not be eliminated.

(iv) **Commission Discussion and Findings.** The Commission recognizes the value of incentive compensation plans as part of an overall compensation package to attract and retain qualified personnel. The criteria for the recovery of incentive compensation plan costs are well established. We allow recovery in rates when: (1) the incentive compensation plan is not a pure profit-sharing plan, but rather incorporates operational as well as financial performance goals; (2) the incentive compensation plan does not result in excessive pay levels beyond what is reasonably necessary to attract a talented workforce; and (3) shareholders are allocated part of the cost of the incentive compensation program. *N. Ind. Pub. Serv. Co.*, Cause No. 43526, 2010 Ind. PUC LEXIS 294, at *195-96 (IURC Aug. 25, 2010).

In Petitioner's last three litigated rate cases, we have found Petitioner's AIP to be recoverable under this standard. Similarly, there is no dispute in this case that the AIP is recoverable: the only dispute is how much should be allocated to customers. Petitioner requests an AIP payout level at 100% of target level, based on a three-year-average payout of 100.33% of target. In *S. Ind. Gas & Elec. Co.*, we authorized recovery of 100% of the incentive plan target level. Cause No. 43839, 2011 PUC LEXIS 115, at *148-151 (IURC Apr. 27, 2011). However, in that case, the evidence demonstrated that the petitioner's average payout had exceeded target by as much as 190% over the past ten years, and that shareholders absorbed the cost of incentive compensation that exceeded the target level.

Here, Petitioner's evidence indicates that the three-year average payout was 100.33% of target level. Yet, Petitioner requests recovery of the full target level: in essence, leaving shareholders to pay only the extra 0.33%. In addition, a review of Petitioner's past several rate cases demonstrates that Petitioner's incentive payout has not typically exceeded the target level. Authorizing Petitioner to recover 100% of the AIP target level, would not allocate a sufficient amount of the incentive costs to shareholders. Therefore, we conclude that Petitioner shall recover 85% of the three-year average payout based on 358 employees with a further reduction to eliminate the incentive pay associated with the Senior Manager Business Development position. This results in a pro forma AIP expense of \$587,416.

The OUCC also recommended that we disallow recovery of expenses for Petitioner's LTIP. Mr. VerDouw testified that Petitioner strives to provide employees with a base compensation at the 50th percentile of the market and the opportunity to earn up to the 65th percentile through AIP. Petitioner's top executives then have an opportunity to earn additional compensation through the LTIP. LTIP is based on the total shareholder return and internal performance goals. Although the LTIP is not a pure profit-sharing plan, it is strongly tied to financial performance in that the Board of Directors determines the level of additional compensation. In addition, the Commission notes that given the current economic climate and the other increases being requested by Petitioner in this case, it is reasonable for Petitioner to mitigate rate increases and control costs where possible. Therefore, we find that Petitioner's LTIP expense should be borne by its shareholders rather than its ratepayers, and we disallow the pro forma LTIP expense.

(c) **Overtime Pay.**

(i) **Petitioner's Position.** Petitioner based its proposed pro forma overtime expense on a two-year average of overtime hours rather than a three-year average. Mr. VerDouw explained that Petitioner was able to capture overtime savings in the last two years, therefore, a two-year average was used.

(ii) **OUCC's Position.** The OUCC proposed a pro forma overtime expense of \$986,688 based on the OUCC's proposed staffing levels.

(iii) **Petitioner's Rebuttal.** Mr. VerDouw testified that he disagreed with the OUCC's elimination of twelve positions from Indiana-American's pro forma labor headcount. Therefore, he recommended overtime expense of \$998,408.

(iv) **Commission Discussion and Findings.** Based on our findings above regarding the pro forma employee level, we accept the OUCC's pro forma overtime expense of \$986,688.

(d) **Miscellaneous Labor Expenses.** Petitioner's 401(k) expense, DCP Expense, Overtime Expense, group insurance, and payroll taxes are dependent on the number of full-time employees. The OUCC and Petitioner proposed alternative employee headcounts and, thus, alternative expense amounts. Based on our finding above, we conclude pro forma 401(k), DCP Expense, group insurance, and payroll taxes should be calculated based on a headcount of 358 with a further reduction to eliminate the Business Development Manager position as discussed below. Of these components, 401(k) and DCP are a component of Miscellaneous Expense; Group Insurance is a category of expense by itself; and Payroll Taxes are a Tax Expense.

(e) **Total Labor Expense.** Based on our findings above, we find Petitioner's total pro forma Labor Expense is \$17,021,654, which is an increase of \$1,187,706 from the test year.

(2) **Support Services Expense.**

(a) **Petitioner's Position.** Petitioner proposed several adjustments to Support Services Expense including: (1) elimination of one-time costs; (2) elimination of disputable expenses; (3) elimination of lobbying and penalty expenses; (4) removal of certain labor and related expenses to reflect certain Service Company employees in Indiana-American Labor Expense; (5) an increase in Service Company payroll to reflect a 2011 merit increase of 3%; and (6) an adjustment to decrease pension and OPEB expense for Service Company employees. Petitioner's total pro forma Support Services Expense is \$19,090,575.

(b) **OUCC's Position.** Ms. Stull accepted all of Petitioner's proposed pro forma adjustments to Support Services Expenses and proposed additional pro forma adjustments including the elimination of certain costs that provide no benefit to ratepayers and are not necessary for the provision of water utility service. Ms. Stull's pro forma adjustment includes: (1) elimination of one-half of Service Company Business Development expenses; (2) elimination of all External Communication expenses; and (3) elimination of non-recurring or

non-allowed expenses. The OUCC's total pro forma Support Services Expense is \$17,846,148.

(i) **Business Development Expenses.** Ms. Stull proposed eliminating one-half of the Business Development expenses included in Support Services Expense, totaling \$275,546. She testified that business development activities primarily benefit shareholders and, only to a lesser extent, ratepayers. Shareholders benefit by increased operating income which, all other things being equal, increases the value of the shareholders' investment in American Water. She also testified that because most of American Water's cost allocations are made on the basis of customer count, a larger customer count also means increased costs will be assigned from the Service Company. Further, a company can only add so many additional business units, and customers, before fixed costs must be increased to operate these additional business units and serve these additional customers. Ms. Stull testified that the matching principal is a basic accounting tenet that requires matching of revenues (benefits) with the costs generating those revenues (benefits). Ms. Stull argues the matching principal should be applied such that ratepayers share Business Development costs on a 50/50 basis with shareholders.

(ii) **External Communications Expenses.** Ms. Stull proposed to eliminate all External Communications expenses from Support Services Expense, including expenses related to Governmental Affairs (\$43,665), External Affairs (\$626,933), Marketing (\$126,895), External Communications (\$78,641), and Social Responsibility (\$53,062), for a total reduction of \$929,196. She cited Ind. Code § 8-1-2-6(c) in support of her adjustment, stating that the External Communications expenses she excluded are institutional or image building, charitable donations, community relations, marketing, and lobbying expenses that could not be included in rates if incurred by Indiana-American and, thus, should not be allowed in rates as a charge from the Service Company. Ms. Stull testified this adjustment of \$929,196 removes expenses that provide no material benefit to ratepayers, and are not necessary for the provision of water utility service.

(iii) **Non-Recurring or Non-Allowed Expenses.** Ms. Stull proposed to remove from Support Services Expense an additional \$39,685 of costs that she contends are either non-recurring or not allowed for ratemaking purposes and include charitable donations, employee awards, flowers, and costs belonging to other jurisdictions. Her proposed adjustment also includes \$10,365 of Price Waterhouse invoices related to the BT Project.

(c) **Petitioner's Rebuttal.**

(i) **Business Development Expenses.** Mr. VerDouw testified on rebuttal that Ms. Stull has no support for her claim that Business Development primarily benefits shareholders. He noted that Ms. Stull and others at the OUCC have attended meetings in which Mr. DeBoy has stated that Indiana-American would not pursue any acquisition unless it is good for Indiana-American and its customers.

Mr. VerDouw also explained that Ms. Stull accepted the adjustment made to Support Services Expense for Service Company employees moved to Indiana-American payroll for rate case purposes. One of the employees moved to Indiana-American payroll was an employee working in the Business Development area. Mr. Patrick accepted the inclusion of that position

as part of his testimony on pro forma labor expense. Accordingly, Ms. Stull's position is inconsistent with Mr. Patrick's acceptance of the adjustment to pro forma labor expense and also results in a double counting of the removal of that position from Support Services Expense.

Mr. VerDouw also pointed out that the allocation formula used to account for Business Development expenses already allocates 50% of those expenses to American Water's non-regulated businesses and therefore 50% of those allocated expenses are already borne by the shareholders. Finally, Mr. VerDouw stated that Business Development activities continue to provide benefits long after a particular contract is negotiated or a deal closed. He presented a calculation of the net benefit to Indiana-American ratepayers of annualized revenues of Business Development activities completed or in progress from 2005 through 2011 as compared to Business Development expense included in Petitioner's rate case, amounting to \$1,854,030.

(ii) **External Communications Expenses.** Mr. VerDouw responded to Ms. Stull's proposed elimination of External Communications expenses by pointing out that under the Commission's rules, Indiana-American is required to provide certain information that is located on the American Water website and is required to keep its rate schedules on its website. In addition, Mr. VerDouw pointed out that the OUCC and other Intervenor in this case have used information from Indiana-American's website to conduct their preparation and to cross-examine Petitioner's witnesses. Accordingly, Mr. VerDouw testified the labor and expenses incurred to maintain the website should not be disallowed.

In addition, just as Ms. Stull had agreed to the adjustment to Support Services Expense related to moving the Service Company employee in the Business Development area to Indiana-American payroll for rate case purposes, so too did she accept a similar adjustment for an employee working in the External Affairs area. Mr. VerDouw explained that the labor and related expense for that employee had already been removed from Support Services – External Affairs expense to Labor Expense and Mr. Patrick had accepted the inclusion of that position as part of his testimony on pro forma labor expense. Once again, Ms. Stull's proposed adjustment represents a "double dipping" of adjustments taken for that position.

Mr. VerDouw stated that, for the most part, the expenses incurred in the External Communications categories are labor and related costs, not the charitable donations, community relations, marketing, and lobbying expenses that are not allowed for ratemaking purposes as Ms. Stull suggests. He stated that although Ms. Stull had all of the information she needed to make specific deductions to any part of External Communications expense that did fit into one of these categories, she instead chose to eliminate all External Communications expense.

Finally, Mr. VerDouw defended the External Communications expense as benefitting ratepayers and permitting Petitioner's compliance with requirements to maintain certain information on its website, including tariff information. He stated that to expect Petitioner to provide these services without recovery of the expense incurred would be unreasonable.

(iii) **Non-Recurring or Non-Allowed Expenses.** Mr. VerDouw agreed that a total of \$14,752 should be deducted from Support Services Expense. He disagreed with the deduction of other expenses from Support Service Expense totaling \$24,933. Mr. VerDouw agreed with Ms. Stull's removal of Price Waterhouse invoices related to the BT

project, since such expenses were non-recurring. He also accepted Ms. Stull's adjustment in the amount of \$4,387 for expenses paid for other jurisdictions. However, he disagreed with the remaining deductions made by Ms. Stull. First, Mr. VerDouw testified that none of the items in the list provided by Ms. Stull in MAS Attachment 28 were related to charitable deductions or flowers. He stated the majority of the remaining items Ms. Stull removed from Support Services Expense were for Service Company recognition awards for employees celebrating milestone anniversaries with the Service Company, plus expenses related to employee meetings, work-related promotions, and other employee functions. Mr. VerDouw defended the inclusion of such expenses as serving a valuable role in maintaining and enhancing employee morale, which helps to insure customers experience a high level of service.

(d) **Commission Discussion and Findings.**

(i) **Business Development Expenses.** Mr. VerDouw defended Petitioner's proposed Business Development expense by presenting an analysis purporting to show a net benefit of \$1,854,030 to ratepayers since 2005 as a result of Business Development activities. We find Mr. VerDouw's analysis to be flawed. First, the analysis includes wholesale revenues received from the New Whiteland acquisition, a significant portion of which would be included in test-year revenues, and thus effectively lost, once the acquisition is complete. In addition, Mr. VerDouw's analysis only includes annualized revenues for each deal type. The analysis does not consider the additional annual operating and capital costs incurred by the Company. The Commission finds no evidence that the Business Development activities provide a benefit to ratepayers – in fact, the Commission is concerned that ratepayers may be subsidizing business development with limited offsetting benefits. Therefore, we conclude that Petitioner's Business Development expense of \$467,474 should be disallowed. Because we are disallowing Petitioner's Business Development expense, we also find that \$129,370 of Petitioner's labor expense associated with the Senior Manager Business Development position should be eliminated.

(ii) **External Communications Expenses.** The Commission reviewed the workpapers that Ms. Stull provided to support her proposed external communications expense disallowances. The Commission accepted the proposed disallowances for any item that could be clearly identified as travel, food, entertainment, gifts, donations, grants, advertising for image building, or political contributions. The result is an adjustment of \$221,077 as a decrease in Petitioner's pro forma expenses.

(iii) **Non-Recurring or Non-Allowed Expenses.** Similarly, the Commission reviewed the workpapers that Ms. Stull provided to support her proposed non-recurring or non-allowed expense disallowances. The Commission accepted the proposed disallowances for any item that would be clearly identified as related to other affiliated companies, entertainment, gifts, or sponsorships. In addition, we accepted Ms. Stull's proposed disallowance for the Price Waterhouse invoice. The result is an adjustment of \$27,781 as a decrease in Petitioner's pro forma expenses.

Based on our findings above, we conclude that Petitioner's total pro forma Support Service Expense is \$18,374,243, which is a decrease of \$1,927,059 from the test year.

(3) Purchased Power Expense.

(a) Petitioner's Position. Petitioner's Witness Lewis E. Keathley sponsored five adjustments to fuel and power costs during the test year. The first adjustment, \$304,106, annualized test-year fuel and power increases. Mr. Keathley stated that the Company annualized 2010 expenses by recalculating each fuel and power 2010 invoice using the tariff and riders in place for the December 2010 bills. The recalculated bill amounts were then compared to the actual bills and the difference between these amounts constituted Petitioner's proposed adjustment.

Mr. Keathley then discussed the second adjustment to fuel and power expenses, which was made to update the fuel and power costs based on the latest known energy cost rates in effect for 2011. He explained that, similar to the first adjustment, changes to the tariffs for Petitioner's energy accounts were applied to the 2010 bills to determine what the bill would be in 2011. The adjustments for each account were added together for a total adjustment for 2011 cost changes for fuel and power expense of \$38,542.

Mr. Keathley's third adjustment was to update the fuel and power cost for changes that will occur as a result of the new Warsaw WTP. He stated that the net reduction in fuel and power costs is projected to be \$7,476.

Mr. Keathley's fourth adjustment to fuel and power expense was to reflect the rate increase for Southern Indiana Gas and Electric Company d/b/a Vectren Energy Delivery of Indiana, Inc. ("Vectren Electric") authorized by this Commission in its Order dated April 27, 2011. Petitioner's proposed adjustment in its case-in-chief for Vectren Electric costs was \$8,737, based on an estimated 6% increase. This was updated in Mr. VerDouw's supplemental testimony to reflect the actual increase to applicable Vectren Electric rates of 8%, producing an additional adjustment of \$2,912 for a total adjustment for Vectren Electric costs of \$11,649. Mr. Keathley explained in his direct testimony that although NIPSCO currently had a pending rate increase, due to the uncertainty that existed at that time as to when new rates would be implemented, the Petitioner did not make an adjustment for NIPSCO costs.

Finally, Mr. Keathley proposed an adjustment to reflect the pro forma system delivery calculated by Mr. VerDouw. Mr. Keathley stated that Mr. VerDouw's adjustment reduces the amount of volume assumed for this rate case. The adjustment was calculated by taking the difference between the pro forma system delivery and the test-year system delivery and multiplying that amount by the pro forma fuel and power cost per thousand gallons, resulting in an adjustment to decrease fuel and power by \$56,449.

In his supplemental direct testimony, Mr. VerDouw also proposed an additional adjustment to increase purchased power expense by \$240,000 due to electric usage at Borman Park, which was not being metered during the test year. Apparently, during the course of installing new equipment, it was discovered that a portion of electricity used at Borman Park was not flowing through the meter. A new meter was then installed to capture the usage. Mr. VerDouw's proposed adjustment was based on the April 2011 bill received by Petitioner for this meter, which reflected charges for two months.

Petitioner's total pro forma purchased power expense is \$6,841,614.

(b) **OUCC's Position.** Ms. Stull accepted Mr. Keathley's proposed adjustment for normalization of purchased power tariffs and riders in effect for 2010 and 2011 and for the Vectren Electric rate increase that took effect in May 2011. She then proposed an adjustment for the Warsaw WTP to reduce purchased power expense in the amount of \$10,643 based on a revised calculation of the cost savings associated with the plant provided by Petitioner in discovery.

Ms. Stull also proposed a system delivery adjustment for purchased power expense based on her proposed adjustment for customer growth discussed in the section of this Order addressing operating revenue. Her proposed adjustment increases purchased power costs of \$18,441 related to increased water sales due to customer growth during and subsequent to the test year. Ms. Stull testified that her methodology to calculate this adjustment is similar to Petitioner's methodology.

Ms. Stull also proposed an adjustment for the Borman Park meter of \$206,896 based on additional bills received by Petitioner for this meter for the months of May and June 2011. She testified that her adjustment reflects the average amount of power usage for the months of April, May, and June on an annualized basis.

Ms. Stull proposed an additional adjustment to decrease purchased power costs by \$56,189 due to a major leak discovered and repaired during the test year in the Southern Indiana Operations (the "Southern Indiana Leak"). Ms. Stull testified a leak was discovered in the Southern Indiana District on September 23, 2010. Petitioner represented the leak was causing an estimated loss of over 4 million gallons per day ("GPD"). In response to OUCC Data Request Q 10-3, Petitioner estimated the leak could have started as early as May 2010. Ms. Stull testified that assuming the leak continued over a period of 100 days (May 15 – September 23), a total of 400,000,000 gallons of water would have been lost.

Ms. Stull acknowledged that leaks are generally considered a normal, recurring expense for a water utility that should be considered a normal cost of business. However, a leak of this magnitude that goes undetected for such a long period of time is unusual and therefore not a normal recurring operating expense. She confirmed on cross-examination that she does not assert that the leak should have been prevented or detected sooner; rather that it was non-recurring.

Ms. Stull testified that by excluding the first two weeks in May from her calculation of the water lost through this leak, she has acknowledged that part of the cost of the leak was a normal operating expense. Further, she testified the OUCC did not propose any adjustment for the Richmond leak identified and discussed at the evidentiary hearing held in August 2011. Ms. Stull testified that going forward; all other things being equal, Indiana-American will not need to pump as much water as it did during the test year to generate the same level of sales. Since there is less water pumped, less electricity is used.

The OUCC's total pro forma purchased power expense is \$6,824,044.

(c) **Petitioner's Rebuttal.** Mr. Keathley testified in rebuttal that he

agreed with Ms. Stull's proposed adjustment to reduce purchased power expense for the Warsaw WTP in the amount of \$10,643. Mr. VerDouw responded to Ms. Stull's purchased power adjustment relative to customer growth. As explained above, Mr. VerDouw disagreed with the volumetric additions Ms. Stull made relative to her customer growth adjustment and therefore does not accept Ms. Stull's resulting purchased power system delivery adjustment. As a result, Mr. VerDouw testified that purchased power expense should be reduced by Petitioner's proposed system delivery adjustment in the amount of \$56,449.

With respect to Ms. Stull's proposed adjustment for the by-passed Borman Park meter, Mr. Keathley agreed that the adjustment should be based on as much information as possible. Instead of restricting the calculation to 3 months worth of bills, he updated the adjustment to reflect April, May, June, July, and August 2011 bills for a total adjustment of \$219,413.

Mr. VerDouw responded to Ms. Stull's adjustment to purchased power expense for the Southern Indiana Leak. He referred to the unusual circumstances of the main break as described in greater detail by Bruce A. Hauk's rebuttal testimony. Mr. VerDouw testified that he does not believe singling out an isolated issue for a specific adjustment is prudent or necessary. He noted that Mr. Rees, who addressed the leak in his prefiled testimony, did not provide a recommendation to penalize the Company for this leak. Accordingly, Mr. VerDouw opposed Ms. Stull's pro forma adjustment to reduce purchased power expense by \$56,189.

The effect of Petitioner's rebuttal position is to decrease total pro forma purchased power expense to \$6,817,860.

(d) Commission Discussion and Findings. The Parties agree on some adjustments related to Petitioner's Purchased Power Costs. All parties accepted Petitioner's adjustment for normalization of purchased power tariffs and riders in effect for 2010 and 2011 and for the Vectren Electric rate increase that took effect in May 2011, which we find accept. The Parties also agreed to the revised adjustment to reduce purchased power expense relative to the Warsaw WTP by \$10,643, which we also accept.

Thus, the remaining disputes are the adjustments for system delivery, the Borman Park meter, and the additional adjustment proposed by the OUCC for the Southern Indiana Leak. As discussed above, consistent with our past decisions, we reject Ms. Stull's volumetric additions relative to post-test-year customer growth. As a result, we also reject her corresponding adjustments to the purchased power adjustments for system delivery.

With respect to the adjustment for the Borman Park meter, we find that Petitioner and the OUCC generally agree to the use of the most recent information available for calculating the appropriate adjustment. Mr. Keathley's rebuttal testimony provides the most up-to-date billed amounts for the Borman Park meter. Accordingly, we find that the proposed adjustment based on this, more recent information is appropriate and accept the adjustment of \$219,413, proposed in Mr. Keathley's rebuttal testimony.

We agree with Petitioner that, in general, an adjustment for a specific leak is not warranted. Leaks are a normal cost of business for a water utility. However, this particular leak was of an unusual magnitude and circumstance. Mr. VerDouw explained that the leak occurred

in a location that made it hard to detect. The water from the leak flowed directly into a nearby creek, and, thus, did not flood the area. In addition, the leak occurred at the beginning of summer seasonal usage, which made a sudden increase in flow seem unremarkable. This combination of circumstances allowed the leak to go undetected for several months. Petitioner's evidence states that the leak caused an estimated loss of over 4 million GPD. Ms. Stull estimated that between May 15 and September 23, 2010, the leak resulted in a total loss of 400,000,000 gallons of water.

Based on this evidence, we conclude that the leak was sufficiently exceptional to constitute a non-recurring event. Therefore, we accept Ms. Stull's proposed adjustment. However, on rebuttal, Petitioner identified a mistake in Ms. Stull's calculation and indicated the adjustment should actually be \$63,029. We conclude that the proposed adjustment of \$63,029 is reasonable. The result is a total adjustment of \$443,589, which increases Purchased Power test-year expense to \$6,754,830.

(4) Chemical Expense.

(a) Petitioner's Position. Petitioner's Witness Keathley testified that three adjustments are necessary for chemical expenses, totaling \$20,253. He explained that the first adjustment was necessary to annualize the 2011 chemical prices. He explained that the 2011 chemical price was multiplied by the quantity of chemical units used in 2010 to obtain the 2011 pro forma amount. The 2010 chemical amount was then subtracted from the 2011 pro forma amount, which results in a \$161,991 reduction in chemical expense.

Mr. Keathley's second adjustment to chemical expense accounts for Mr. VerDouw's revenue adjustments based on water sales. The result is a \$21,656 reduction in chemical expense, calculated by taking the difference between the pro forma units and the test-year units and multiplying that amount by the 2011 chemical price.

Mr. Keathley's final adjustment to chemical expense was for chemical treatment changes that are being implemented in 2011 and are based on an analysis by Indiana-American operations department. These changes are for new drinking water regulations, algae control, and the Warsaw WTP. Mr. Keathley explained that Kokomo, Richmond, and Muncie Operations will require operational changes in 2011 in order to comply with the new drinking water regulations to control disinfection byproducts - Stage 2 Disinfectants and Disinfection Byproducts Rule ("Stage 2 DBP Rule"). He testified that Petitioner's Kokomo and Richmond Operations will change their surface water treatment to include chemical oxidation with permanganate and the application of ammonia to form chloramines at the entry point to the distribution systems. He stated the additional chemical treatment costs based on 2011 prices will amount to approximately \$50,000 for Kokomo and \$58,000 for Richmond. With respect to the Muncie Operation, Mr. Keathley testified it will reduce DBPs seasonally by decreasing the water age in the distribution system, which will require seasonal flushing plus chemical treatment of the flushed water to remove the disinfectant residual at an estimated cost of \$39,000. The total adjustment proposed by Mr. Keathley as a result of these new drinking water regulations is \$147,000. To provide algae control for the Muncie and Richmond operations in 2011, Mr. Keathley stated the additional chemical treatment costs are estimated to be \$3,000 for Muncie and \$3,500 for Richmond. Mr. Keathley also proposed an adjustment for additional water treatment costs of

\$50,400 per year that will be incurred in 2011 at the Warsaw WTP due to feeding sodium hypochlorite, fluoride, sodium permanganate, and polymer.

Petitioner's total pro forma chemical expense is \$2,245,177.

(b) OUCC's Position. Ms. Stull accepted Petitioner's adjustment to normalize 2011 chemical prices, but proposed adjustments that provide for a net overall decrease of \$176,207 to test-year chemical expenses. Ms. Stull's first adjustment to chemical expense was an increase of \$5,536 to reflect the additional cost due to test-year and post-test-year customer growth based on her revenue adjustment for customer growth.

Ms. Stull did not agree with Petitioner's proposed adjustments for chemical treatment changes related to new drinking water regulations, algae control, and the Warsaw WTP, citing lack of supporting documentation or calculations for the amounts for each adjustment. She noted that Petitioner had responded to discovery requests for supporting documentation for the proposed chemical treatment adjustments by stating that the additional chemical cost estimates were the product of its professional and experienced engineering staff. She testified that Petitioner had failed to provide supporting documentation on which she could make a determination as to the reasonableness of the proposed adjustment. Ms. Stull also took issue with the proposed increase to chemical costs for the Warsaw WTP based on the Petitioner's proposed decrease in purchased power costs as a result of the efficiencies gained by the new Warsaw WTP. She stated it would be reasonable to expect the same decrease with respect to chemical costs as for purchased power costs. Ms. Stull concluded that Petitioner had not met its burden of proof with respect to its proposed adjustments and therefore the chemical expense adjustments for chemical treatment changes should be disallowed.

Ms. Stull also recommended a reduction to chemical expense for the Southern Indiana Leak in the amount of \$19,752.

(c) Petitioner's Rebuttal. Mr. VerDouw opposed Ms. Stull's proposed adjustment to chemical expense for system delivery based on his opposition to the Ms. Stull's volumetric adjustments for customer growth. He testified that the Company's proposed system delivery chemical expense reduction of \$21,656 should stand. Mr. Keathley disagreed with Ms. Stull's methodology in calculating the adjustment. Mr. Keathley stated that Ms. Stull uses total chemical costs to calculate her cost per thousand gallons, but a more accurate methodology is to calculate the cost per chemical, based on the pro forma system delivery and the quantity of each chemical used per thousand gallons.

Petitioner's Witness Hoffman addressed Ms. Stull's proposed adjustment for chemical treatment changes related to the Stage 2 DBP Rule. Mr. Hoffman first corrected Ms. Stull's description of the Warsaw WTP, clarifying that although Ms. Stull's testimony stated that the Warsaw WTP is replacing existing treatment plants, one of which is a surface water plant, the Company has not operated any surface water treatment plants in Warsaw since acquiring the utility in 2000 and all of the existing treatment plants are ground water treatment plants. Mr. Hoffman testified that Petitioner accepts Ms. Stull's proposed 2011 pro forma chemical expense for the Warsaw WTP.

Mr. Hoffman then provided updated estimates of chemical costs for the new drinking water regulation projects, with a proposed adjustment amount of \$70,995. Mr. Hoffman explained that the difference between Petitioner's original proposed adjustment and the updated estimates is due to the fact that the previous estimate was developed early in the project design phase and since then the Company has been operating the new chemical feed systems and flushing outlets for a few months and is able to provide a more accurate determination of feed rates and flush volumes. He proposed that the DBP-related chemical and power expenses be based on the updated estimates. Mr. Keathley took issue with Ms. Stull's rejection of the chemical expense adjustment for algae control. He testified that Ms. Stull had removed the adjustment without comment or testimony, and it was therefore arbitrarily excluded without cause or reason. Accordingly, Mr. Keathley opined that the Company's chemical expense adjustment for algae control of \$6,500 should stand.

Mr. VerDouw provided rebuttal testimony responding to Ms. Stull's third adjustment to chemical expense to account for water lost in the Southern Indiana Leak. He reiterated that singling out the Southern Indiana Leak for a specific adjustment is neither prudent nor necessary and that Mr. Rees did not provide a recommendation to penalize the Company for the leak. Accordingly, he disagreed with Ms. Stull's pro forma adjustment to reduce chemical expense for the Southern Indiana Leak.

The Company's proposed pro forma chemical expense after rebuttal was \$2,118,772.

(d) Commission Discussion and Findings. We have previously addressed and rejected the OUCC's proposal to make volumetric adjustments to Petitioner's revenue and expenses. Therefore, we accept Petitioner's position with respect to the customer growth adjustment to chemical expenses.

Ms. Stull also proposed disallowing certain chemical treatment adjustments because they were not supported by documentation. On rebuttal, Petitioner supplied documentation for most of the expenses. However, our review of Petitioner's evidence did not uncover documentation to support the \$6,500 expense for algae control at the Muncie and Richmond Operations. Therefore, we accept the adjustment proposed by Petitioner in its rebuttal less the \$6,500 algae control expense, resulting in an increase to Petitioner's chemical expense of \$70,955.

Finally, as we discussed above, we find that the Southern Indiana Leak constitutes a non-recurring event, and we agree with Ms. Stull that it is appropriate to make an adjustment to Petitioner's chemical expenses to account for it. Therefore, we adopt the OUCC's decrease of \$19,752 to chemical expenses. Based on the evidence, we approve an adjustment of \$132,444, which decreases Chemical test-year expense to \$2,092,480.

(5) Waste Disposal Expense.

(a) Petitioner's Position. Mr. Keathley proposed three adjustments that, in combination, reduce waste disposal expense: a true-up adjustment; an adjustment for the Northwest Ogden Dunes sludge removal; and an adjustment for revised future tonnage of sludge removal. The total of these proposed adjustments reduces waste disposal expense by \$961,981. Total pro forma waste disposal expense is \$2,291,817. Mr. Keathley explained that the waste

disposal true-up adjustment amounts to a reduction of waste disposal expense of \$33,252 for the districts of Kokomo, Noblesville, and Northwest Ogden Dunes to update the accruals to ensure that the accrued amount equals the estimated amounts based on the most recent bills and the revised estimates for sludge removal and waste disposal. The adjustment for Northwest Ogden Dunes sludge removal reflects an additional amount of \$1,403,785 that was expensed in 2010 due to a greater amount of sludge that was required to be removed than originally estimated. Mr. Keathley explained that the Ogden Dunes sludge lagoon was to be closed per an agreement with the Indiana Department of Environmental Management for future use as a storm water collection basin. Mr. Keathley proposed to amortize the \$1,403,785 over five years with an annual amortization amount of \$280,757. As a result, the proposed adjustment eliminates all but one year's worth of the five year amortization, or \$1,123,028.

The final waste disposal adjustment proposed by Mr. Keathley was for revised estimates of the tonnage of sludge that will need to be removed from the sludge lagoons at Marlin 1, Blue River 1, and Ogden Dunes. He stated the estimates are based on measuring the current depth of the sludge in the lagoons and projecting additional accumulations until the next cleaning. Comparing this revision to the 2010 costs results in an adjustment for the Marlin 1 Lagoon of \$3,888 over ten years, or \$389 per year and an adjustment for the Blue River 1 lagoon of \$14,251 over 20 years, or \$713 per year. Initially, Mr. Keathley also proposed an adjustment for the Northwest Ogden Dunes lagoon in the amount of \$194,299 over the 2010 cost. However, in response to discovery requests from the OUCC, Mr. Keathley acknowledged that this amount was in error and withdrew the request for the \$194,299 adjustment for the Northwest Ogden Dunes lagoon. Mr. Keathley's proposed total adjustment for all the revised tonnage, after removing the Northwest Ogden Dunes lagoon amount, is \$1,102.

(b) OUCC's Position. Ms. Stull accepted Petitioner's accrual true-up adjustments of -\$33,252 and revised tonnage adjustments for the Johnson County and Shelbyville Districts in the amount of \$1,102. She also proposed additional accrual adjustments for the Kokomo, Noblesville, and Northwest Indiana districts and proposed changes to the Petitioner's Ogden Dunes sludge removal adjustment.

Ms. Stull calculated an additional decrease of \$10,781 to the waste disposal accrual for the Kokomo District to reflect Petitioner's current estimate of annual waste disposal expense based on the difference between Petitioner's annual accrual amount of \$50,016 as reported in its workpapers and adjusted test-year expense of \$60,797. Similarly, she calculated an additional decrease of \$61,087 to the waste disposal accrual for the Noblesville District to reflect Petitioner's current estimate of annual waste disposal expense based on the difference between Petitioner's annual accrual as reported in its workpapers and adjusted test-year expense of \$71,851.

Ms. Stull also made a similar adjustment for the Northwest Indiana District (excluding Ogden Dunes lagoon cleaning costs) using the monthly annual waste disposal accrual amount as reported in Petitioner's workpapers and multiplying by twelve to yield annual waste disposal accrual of \$450,816. She calculated test-year expense for the same accruals in the amount of \$535,024 based on her review of test-year transactions for the Northwest Indiana District. Decreasing that amount for Petitioner's proposed true-up adjustment of \$26,508, Ms. Stull calculated an adjusted test-year expense of \$508,516, which was \$57,700 more than her

estimated annual waste disposal accrual. Accordingly, she proposed a decrease of \$57,700 to waste disposal accrual expense for the Northwest Indiana District.

With respect to the Northwest Ogden Dunes lagoon cleaning costs, Ms. Stull accepted Petitioner's proposed amortization period for the costs, but disagreed with the costs included in the amortization calculation and proposed a decrease of \$1,213,028 to Petitioner's pro forma waste disposal expense as opposed to Petitioner's proposed decrease of \$1,123,028. She noted that in response to discovery requests from the OUCC, Petitioner acknowledged that the estimate of costs to clean the lagoon were revised in June 2011 based on meetings with its consultant and contractor, reducing those costs from \$1,200,000 to \$750,000. Accordingly, Ms. Stull reduced cleaning costs by \$450,000 and proposed an adjustment based on annual amortization of \$190,757. Ms. Stull acknowledged that Petitioner has since indicated the estimated costs will be higher than the \$750,000 but has not determined what that higher amount would be.

Ms. Stull's proposed adjustments provide for a net overall decrease to test-year waste disposal expense in the amount of \$1,374,746. Her pro forma waste disposal expense was \$1,879,051.

(c) **Petitioner's Rebuttal.** Mr. Keathley responded to Ms. Stull's pro forma waste disposal expense level. He accepted her additional accrual adjustments for Kokomo (a reduction of \$10,781) and Noblesville (a reduction of \$61,087) and her adjustment to the Northwest Ogden Dunes lagoon cleaning costs. However, he opposed Ms. Stull's proposed additional adjustment to the waste disposal accrual for the Northwest Indiana District. He explained that Petitioner's test-year waste disposal expense for Northwest Indiana includes not only accruals for waste disposal expense, as do Kokomo and Noblesville, but also includes direct charged expenses relative to waste disposal for items such as sample testing and cleaning of basin. Mr. Keathley testified that these direct charged waste disposal expenses are normal and recurring and are reflective of a typical test-year expense for waste disposal expense for the Northwest District. He stated that Ms. Stull had included only accrued amounts in her pro forma test-year expense for Northwest District waste disposal expense and removed direct charge items in the amount of \$57,700. He explained that while this was the proper approach for Kokomo and Noblesville, he believes the direct charge items for the Northwest District are proper expenses and should not be adjusted out of pro forma waste disposal expense for the Northwest District.

Mr. Keathley noted that because the Company's engineering team is still in the process of revising the cost estimate for the Northwest Ogden Dunes lagoon cleaning costs, Petitioner is accepting Ms. Stull's adjustment to reduce total lagoon cleaning costs to \$953,785, to be amortized over five years for an annual expense of \$190,757.

On rebuttal, the Company's total adjustment is a decrease of \$1,317,046, producing total pro forma waste disposal expense of \$1,936,751.

(d) **Commission Discussion and Findings.** Having reviewed the evidence, we find that Petitioner has sufficiently addressed Ms. Stull's remaining issues. Accordingly, we accept Petitioner's revised total adjustment of \$1,317,046, which decreases Waste Disposal test-year expense to \$1,936,751.

(6) **Miscellaneous Expense.** Petitioner proposed eleven separate adjustments to Miscellaneous Expense to produce total pro forma Miscellaneous Expense of \$6,696,875, an increase of \$162,984 over the test year. The adjustments include: (a) an increase to 401(k) expense in the amount of \$70,726; (b) an increase to DCP expense of \$50,604; (c) a decrease of \$25,751 to eliminate labor costs; (d) an increase to legal costs in the amount of \$79,638; (e) an increase to security expense in the amount of \$29,682; (f) a decrease to vehicle insurance in the amount of \$7,703; (g) the elimination of penalty expenses in the amount of \$3,927; (h) a decrease to leased vehicle expense in the amount of \$259,687; (i) an increase in fuel costs by \$225,626 due to an increase in gasoline prices; (j) a decrease to expenses related to the "Call Before You Dig" program in the amount of \$2,644; and (k) an increase in the amount of \$6,421 to reflect increases in National Association of Water Companies ("NAWC") and American Water Works Association ("AWWA") dues. The OUCC accepted Petitioner's adjustments for vehicle insurance, the elimination of penalty expenses, and the "Call Before You Dig" program. On rebuttal, Petitioner accepted the OUCC's rejection of the adjustment to eliminate certain expenses labeled as "labor expenses." The OUCC noted that the labor expense adjustment is unnecessary as the expense is properly recoverable. Petitioner also accepted Ms. Stull's calculation of additional security expense to be included as a pro forma adjustment and agreed with her adjusted amount of \$23,313. In addition, Petitioner accepted Ms. Stull's adjustment of \$2,883 for AWWA and NAWC dues. Total pro forma Miscellaneous Expense reflected in Indiana-American's rebuttal position is \$6,575,342. We have already addressed the adjustment to 401(k) and DCP Expense in connection with our discussion of labor positions, and therefore find that the OUCC's adjustment to increase these amounts by \$57,754 and \$30,033 respectively should be approved. In addition, we have reduced Petitioner's 401(k) expense by \$1,554 and DCP Expense by \$6,792 to account for the removal of expenses associated with the Senior Manager Business Development position. The other disputed Miscellaneous Expense adjustments are addressed in detail below.

(a) **Legal Expense.**

(i) **Petitioner's Position.** Mr. VerDouw proposed to adjust legal expense to the budgeted 2011 level. He testified that legal expense varies year by year and depends on the number of cases and activities requiring legal expertise. The Company determined that the 2011 budgeted level of legal expense would reflect the most reasonable expense level. Using this assumption, the pro forma adjustment for legal expense increases miscellaneous expense by \$79,638.

(ii) **OUCC's Position.** Ms. Stull testified that Petitioner based its pro forma legal expense on the amount included in its 2011 budget. She testified that a budgeted number, without any further supporting documentation, is not a reasonable basis on which to base an operating expense adjustment for ratemaking purposes. In prior rate cases, Petitioner proposed an adjustment to legal expense based on an average of legal expense over a three year period. In this case, Petitioner presented a three year average for legal expenses for the years 2008, 2009, and 2010 but based its proposed adjustment on the higher amount included in its 2011 budget.

Ms. Stull testified the OUCC attempted to validate the three-year average presented in Petitioner's workpapers. She said the OUCC requested copies of all test-year legal invoices over

\$1,000, as well as all legal invoices over \$1,000 for the years 2008 and 2009. She stated that Petitioner provided invoices for some vendors that supported the associated legal expense. However, for the remaining legal expense, the support merely consisted of a document with the name of the law firm and the amount due. Ms. Stull testified these documents contained no information regarding the matter for which the legal fees were incurred.

Ms. Stull testified that at a minimum, the supporting documentation should include the subject matter, as well as the date, the name of the attorney providing the service, the hourly rate for each attorney, and the hours worked by each attorney for each matter included in the invoice. Ms. Stull testified that without such information, a reviewing agency is unable to determine whether the legal fees are properly recoverable and includable in pro forma legal expense. Therefore, Ms. Stull proposed a decrease of \$139,327 to eliminate all unsupported test-year legal fees.

(iii) **Petitioner's Rebuttal.** Mr. VerDouw opposed Ms. Stull's position. He noted that Petitioner produced redacted legal invoices in similar fashion to what it had done in prior cases and that the OUCC did not request any further information concerning the invoices it disputed. He also noted that her suggested outcome would result in annual legal expense on a pro forma basis of \$15,000, which he testified is an unreasonable level for a company the size of Indiana-American. He testified that the Commission should accept the Company's original adjustment, which increases the test-year level of legal expense based on the 2011 budget. Barring that, he testified the Commission should accept no adjustment and utilize the test-year level. Since the OUCC is proposing to disallow much of the test-year level of expense, he testified the OUCC bears a greater burden of explaining why it believes these expenses should be disallowed.

(iv) **Commission Discussion and Findings.** Adjustments to test-year expenses must be fixed, known, and measurable. We agree with the OUCC that it is not appropriate to base adjustments on a budgeted amount without any supporting documentation. Petitioner bears the burden of producing documentation that sufficiently details the expenses and requesting confidential treatment of information when appropriate. However, we disagree with the OUCC's proposal to remove almost all test-year legal expense. Petitioner's test-year level of legal expense is \$154,362. Because Petitioner has not met its burden of proof with respect to any adjustment to the test year, we conclude Petitioner's total legal expense is \$154,362.

(b) **Leased Vehicle Expense.**

(i) **Petitioner's Position.** Mr. VerDouw explained that the Company is converting its fleet from leased vehicles to owned vehicles. As leases expire, the Company is purchasing new vehicles. He reviewed the Company's list of vehicles with leases that expire in 2010 and made adjustments to remove the lease expense. He proposed an adjustment to reduce leased vehicle expense in the amount of \$259,687.

(ii) **OUCC's Position.** Ms. Stull accepted Petitioner's adjustment and added an additional adjustment of \$87,264 to eliminate rental expense for vehicle leases that will expire during the adjustment period. Ms. Stull testified the basic difference

between her proposed adjustment and Petitioner's adjustment is the definition of pro forma expense for rate-making purposes. She said Petitioner's adjustment is based on the number of months billed in 2011, while her adjustment is based on the recurring annual expense Petitioner will incur subsequent to the test year. Ms. Stull indicated there were numerous vehicles whose leases expired during 2011. She said based on Petitioner's change in practice of purchasing vehicles rather than leasing them, Petitioner should not be renewing these vehicle leases. Therefore, her adjustment eliminates all vehicle leases that expire within 2011 yielding a recurring annual expense of \$1,294,628 or a decrease of \$346,951 to test-year leased vehicle expense.

(iii) **Petitioner's Rebuttal.** Mr. VerDouw opposed the additional adjustment for leases expiring in 2011. He noted the vehicles with leases expiring in 2011 will need to be replaced with a purchased vehicle, which Ms. Stull did not include in her total rate base. He noted that it would be improper to remove the rental expense without also matching it with the increase to rate base.

(iv) **Commission Discussion and Findings.** Ms. Stull proposed that we disallow expense associated with vehicles whose leases will expire in 2011 and will need to be replaced, but she did not propose an adjustment to account for the replacement of the vehicles. Therefore, we approve Petitioner's proposed adjustment to leased vehicle expense of \$259,687 as a decrease in test-year expense.

(c) **Fuel Expense.**

(i) **Petitioner's Position.** Mr. VerDouw proposed an adjustment to gasoline and diesel costs. The gasoline and diesel costs for the Company's fleet for the actual test year reflected an average cost of \$2.77 per gallon. On April 29, 2011, a survey provided by Gasbuddy.com showed the gasoline prices in the State of Indiana were as high as \$4.35 a gallon in Gary and averaged \$4.17 per gallon across the state. Diesel prices were even higher. He testified that Gasbuddy.com is a website that offers a real time gas price forum so that consumers can access the most current local gas prices available. He proposed an adjustment, which he styled as conservative to reflect the cost of gasoline and diesel fuel at \$4 per gallon. This resulted in an increase to fuel prices of \$225,626.

(ii) **OUC's Position.** While expressing some reservation about his assumptions, Ms. Stull ultimately accepted Mr. VerDouw's methodology, but she proposed a different price per gallon. She visited Gasbuddy.com at a different date and proposed a current gas price of \$3.258 per gallon. Her proposed adjustment was an increase of \$89,516.

(iii) **Petitioner's Rebuttal.** On rebuttal, Mr. VerDouw pointed out that his survey of Gasbuddy.com came at perhaps the highest gas price of the year and that Ms. Stull's survey was made at perhaps the lowest price of the year. He noted that the average price of unleaded gasoline in the State of Indiana has been above \$3.50 almost continually from the period of March 1 through September 20, 2011. The average price on October 13, 2011 was \$3.468 per gallon. He proposed on rebuttal that the average price be set at \$3.50 per gallon which would produce a pro forma adjustment of \$128,038.

(iv) **Commission Discussion and Findings.** The price of gasoline and diesel fuel has been extremely volatile over the course of the last few years. Therefore, the use of an average price per gallon as a proxy for a reasonable level of expense is appropriate. Based on the various charts and graphs presented by Mr. VerDouw and Ms. Stull, we find that \$3.50 per gallon is a reasonable average price. Accordingly, we accept Petitioner's proposed adjustment as modified on rebuttal. The result is an adjustment of \$128,038 as an increase in test-year expense.

(d) **Non-Recurring/Non-Allowed Expenses.**

(i) **OUC's Position.** Ms. Stull proposed an adjustment to eliminate non-allowed and non-recurring expenses that provide no material benefit to ratepayers and are not necessary for the provision of water utility service. She said these expenses should not be borne by ratepayers and include, among other things, image building expenses such as sports sponsorships, memberships in civic organizations, and other community relations expenses, as well as charitable donations, golf outings, employee awards, and non-allowed advertising expenses. She testified the Commission has disallowed these types of expenses in prior Indiana-American rate cases including Cause Nos. 42029, 42520, 43187, and 43680.

She said her adjustment does not eliminate any Chamber of Commerce dues because the Commission has allowed these expenses to be included in operating expenses. However, she said if she could identify an expense labeled as "Chamber of Commerce" as an expense for a sports sponsorship, advertising, or other non-allowed type of activity, then she did exclude it. She said she does not believe the Commission intended to allow these types of expenses under the guise of paying them to a Chamber of Commerce organization. Ms. Stull proposed a decrease of \$163,387 for these non-allowed and non-recurring expenses.

(ii) **Petitioner's Rebuttal.** Mr. VerDouw noted that one of Ms. Stull's proposed adjustments for \$3,900 was to eliminate a penalty that the Company had already removed. He also opposed her elimination of employee awards and recognition for celebrating milestone anniversaries which accounted for \$26,501. He noted that many of these expenses were incurred to make sure that employees are involved in their communities by supporting their membership in local Rotary Clubs, Kiwanis Clubs, and various local economic development groups. Doing so benefits customers. He also noted that Ms. Stull is proposing to eliminate membership dues and various other miscellaneous costs that he described as the cost of doing business and included everything from educational items to manning a booth at the State Fair. He did accept \$39,789 of her reductions.

(iii) **Commission Discussion and Findings.** Petitioner accepted \$39,789 of Ms. Stull's adjustment, but contested the remaining \$123,599. Petitioner contended that Ms. Stull removed \$3,900 for a penalty, which Petitioner had already removed, and we agree this amount should be reduced from Ms. Stull's adjustment. Based on our review of the remaining adjustments, we find they are not reasonably necessary for the provision of water utility service to ratepayers. Therefore, we accept Ms. Stull's adjustment of \$163,387 minus the \$3,900 penalty, for a total adjustment of \$159,487 as a decrease in test-year expense.

(e) **Total Miscellaneous Expense Adjustment.** Based on the discussion above, we conclude Petitioner's total pro forma Miscellaneous Expense is \$6,334,088, which is a decrease of \$199,773 from the test-year.

(7) **Rent Expense.**

(a) **Petitioner's Position.** Petitioner proposed a pro forma decrease to rent expense in the amount of \$44,477 to reflect a negotiated decrease in the Greenwood Corporate Office Lease that takes effect in 2011.

(b) **OUCC's Position.** Ms. Stull accepted Petitioner's proposed adjustment for the Greenwood office lease and proposed an additional adjustment to remove the costs of leasing the Bibler plant property in the Warsaw District in the amount of \$16,469. Ms. Stull testified that as part of Petitioner's new Warsaw WTP, the existing water treatment plants and well fields will be retired. In response to OUCC Data Request Q-19-4 Petitioner indicated the Bibler plant property was not owned by Indiana-American and was being leased. During the test year, Petitioner incurred \$16,469 of lease payments for the Bibler plant property. Ms. Stull's proposed adjustment eliminates these test-year lease payments.

(c) **Petitioner's Rebuttal.** Mr. Hoffman opposed Ms. Stull's additional adjustment related to the Bibler wellfield lease. He explained that although Petitioner will not be using the Bibler wellfield with the new Warsaw WTP, Petitioner has certain remaining obligations under the lease agreement for the property, including an obligation to pay a termination fee in the amount of the annual lease cost. Because the Company has needed to maintain use of the wellfield until the Company is comfortable with the operation of the new treatment plant, and because the lease requires removal of all facilities within 60 days of notice of lease termination, Mr. Hoffman explained that the Company cannot yet provide notice of lease termination to the Lessor. He testified that the Company plans to provide notice to the Lessor in November 2011, once it is satisfied with operation of the new treatment facility, and will be able to remove the existing facilities at the Bibler wellfield. Mr. Hoffman stated that because the Company has incurred the cost of the lease in the 2010 test year, and has incurred the cost of the lease in 2011, and will incur the cost of the lease termination fee in the amount of the annual lease amount which will essentially equate to a lease cost for 2012, two years after the test year, the Company believes it to be fair and appropriate for the Company to recover these costs.

(d) **Commission Discussion and Findings.** The parties agree with the adjustment of \$44,477 for the Greenwood corporate office lease, and we accept this adjustment. With respect to the Bibler wellfield, we agree with Ms. Stull that once the Warsaw WTP is functioning, Petitioner will no longer need the Bibler wellfield. Therefore, the annual lease expense should be eliminated. However, as Mr. Hoffman testified, Petitioner will be responsible for a lease termination payment. It is appropriate that Petitioner be able to recover this cost through rates. However, the cost is non-recurring and is therefore not appropriately recovered as a pro forma expense adjustment. Therefore, Petitioner shall account for the termination fee as a regulatory asset amortized over two years – the expected period Petitioner's rates from this case will be in effect. Accepting Ms. Stull's calculation that annual lease cost is \$16,469 and Mr. Hoffman's testimony that the termination fee equals the annual lease cost, the result is a pro forma adjustment of \$8,235. Therefore, we conclude Petitioner's total rent

expense adjustment is \$52,712 as a decrease in test-year expense.

(8) **Group Insurance.** The OUCC accepted Petitioner's proposed adjustment for Other Post-Employee Benefits of \$719,844 as a decrease in test-year expense. The only dispute is with respect to Group Insurance is \$98,700 and it relates to total headcount in pro forma labor. We previously accepted the OUCC's count of 358 full-time employees; therefore we also accept the OUCC's adjustment of \$696,467 as an increase in test-year expense. However, we previously removed the Senior Manager Business Development position from rates. Therefore, we have reduced test-year expense by \$6,321, which results in a pro forma expense adjustment of \$690,146. We conclude the total Group Insurance adjustment is a test-year decrease of \$29,698, resulting in a pro forma insurance expense of \$3,639,343.

(9) **Customer Accounting Expense.**

(a) **Petitioner's Position.** Petitioner proposed two adjustments to customer accounting expense: (1) an increase to uncollectible expense of \$406,224 based on a three year average uncollectible expense rate of 1.1772%; and (2) an increase of \$15,666 to postage expense based on rate increases implemented in April 2011.

(b) **OUCC's Position.** Ms. Stull accepted Petitioner's methodology for calculating both uncollectible expense and postage expense, but proposed different adjustment amounts. She also proposed an adjustment to capture additional postage expense due to customer growth experienced during the test-year and post-test-year periods. Ms. Stull proposed an uncollectible expense adjustment of \$405,903. This differs from Petitioner's proposed adjustment in that it is applied to the OUCC's pro forma operating revenues, which differ from Petitioner's proposed levels as described elsewhere in this Order. In addition, Ms. Stull testified that Petitioner's pro forma uncollectible expense was incorrectly calculated using total operating revenues rather than just water and sewer revenues.

Ms. Stull noted that when Petitioner calculated its pro forma postage expense to account for the increase in postage rates that took effect in April 2011, it applied the new rates only to mail processed after the new rates went into effect. As a result of the correction of this error, Ms. Stull proposed an increase to postage and mailing expense of \$22,666. Ms. Stull also proposed an adjustment to reflect increased postage costs related to additional billings due to customer growth during and subsequent to the test year, yielding increased postage expense of \$11,363.

(c) **Petitioner's Rebuttal.** Mr. VerDouw accepted Ms. Stull's methodology in calculating the uncollectible expense adjustment wherein only water and sewer revenue are included. However, he pointed out that Ms. Stull included her proposed revenue adjustment for late payment fees though such an adjustment would be included in "other" revenue. As a result, Mr. VerDouw's proposed uncollectible expense adjustment is \$368,327.

Mr. VerDouw agreed with Ms. Stull's correction to postage expense of \$22,666. Mr. VerDouw also agreed with Ms. Stull that an adjustment should be made to postage expense for additional billings related to customer growth. However, he calculated an adjustment of \$10,387 for a total postage expense adjustment of \$33,053.

(d) **Commission Discussion and Findings.** The parties agree on the

methodology for calculating the appropriate amount of uncollectible expense, but disagree on the result. The Commission calculated the uncollectible expense adjustment, using Petitioner's proposed 1.772% 3-year average uncollectible rate on water/sewer revenues of \$192,995,582. The result is an adjustment of \$378,464 as an increase in test-year expense.

Petitioner and the OUCC agreed to a postage expense adjustment of \$22,666, and we accept the adjustment. With respect to increased postage for customer growth, the OUCC made its calculation based on customer growth of 33,422. On rebuttal, Petitioner made its calculation based on customer growth of 30,550. We accept Petitioner's rebuttal adjustment calculation of \$10,387. These amounts comprise a total customer accounting adjustment of \$411,517, which increases Customer Accounting test-year expense to \$4,954,641.

(10) General Office Expense.

(a) Petitioner's Position. Mr. VerDouw proposed two pro forma adjustments to the test year for General Office Expense. The first adjustment was made to eliminate labor expenses that were reflected in General Office Expense. The second adjustment was made to eliminate items that may be considered disputable with regard to recovery in a rate case. Rather than argue the recovery of these items, Mr. VerDouw explained that the Company made the determination to eliminate the items up front. The amount of the pro forma adjustment made for these two items decreased test-year General Office Expense by \$4,835.

(b) OUCC's Position. Ms. Stull proposed a net overall decrease to test-year General Office Expense in the amount of \$17,904. Her pro forma General Office Expense was \$1,326,890. She did not accept Petitioner's proposed elimination of general office "labor" expense in the amount of \$838. She testified that, during the on-site accounting audit, Mr. VerDouw explained that these expenses were actually reimbursement of employee out of pocket expenses that are reimbursed to the employee via their paycheck. Ms. Stull stated that she believes these should be considered legitimate operating expenses and should be included in Petitioner's revenue requirement.

Ms. Stull accepted Petitioner's proposed adjustments to eliminate non-allowed expenses but also proposed elimination of additional expenses in the amount of \$13,907, which she identified as not allowed for ratemaking purposes. She described the additional items as providing no material benefit to ratepayers and not necessary for the provision of water utility service. According to Ms. Stull, the items included Rotary Club dues, Kiwanis Club dues, various economic development groups, flowers, and non-work related meals.

(c) Petitioner's Rebuttal. Mr. VerDouw stated that he accepted Ms. Stull's rejection of an adjustment to reduce General Office Expense by \$838 for employee-type expenses that have been reimbursed to the employee via their paycheck.

However, he disagreed with her additional adjustment to reduce General Office Expense by \$13,907 for the items identified in her prefiled testimony. He explained that local district managers and their employees are encouraged to be active members of the communities they serve and that memberships in Rotary Clubs, Kiwanis Clubs, various local economic development groups, and other civic organizations do benefit the customers by giving the

Company an avenue to build partnerships with businesses, communities, and consumers. He stated these activities allow the Company to participate in organizations that guide building and construction standards as well as provide a forum to discuss plans, coordinate building activities and promote programs like water conservation to consumers, fellow utility members, and business and government leaders. Mr. VerDouw testified that such participation benefits the Company's customers and serves to open up communication lines to customers. He then explained that \$2,398 of Ms. Stull's adjustment was for three events that she classifies as non-work related meals when, in fact, they were meals for leadership meetings and training events held for Indiana-American managers and employees. Of Ms. Stull's proposed reduction to General Office Expense, Mr. VerDouw identified \$1,434 as payments to floral shops for flowers sent to employees who were hospitalized and/or to the families of Indiana-American employees when a loved one passed away. Although he believes these payments are a necessary cost of doing business, Mr. VerDouw stated he was willing to concede on this portion of Ms. Stull's adjustment. Accordingly, Mr. VerDouw stated the appropriate adjustment for additional disputable expenses is to reflect a reduction of \$1,434 to General Office Expense.

Petitioner's total pro forma General Office Expense on rebuttal was \$1,339,364.

(d) **Commission Discussion and Findings.** The Parties have agreed that no adjustment should be made to eliminate \$838 of miscellaneous test-year general-office expense for reimbursements for various employee expenses. We conclude these costs are proper expenses to recover through rates.

The Commission also agrees with Ms. Stull's proposed adjustment to eliminate an additional \$13,907 of non-allowed General Office Expenses. In Cause No. 43680, we denied recovery of dues and membership fees in various community organizations, and we remain unconvinced that membership in such associations and organizations is necessary for the provision of utility service to ratepayers. With respect to employee meals at leadership meetings and training sessions, we find it is not reasonable to ask ratepayers to fund these meals in light of the current state of the economy. During the field hearings in this case, we heard from many members of the public who told us how much they have already sacrificed to pay their bills. As Petitioner asks us to approve significant increases in one of those bills, we find it is appropriate for the Company to make sacrifices as well, especially when those sacrifices do not compromise its ability to provide quality utility service. Therefore, we conclude that Petitioner's General Office Expense adjustment is \$17,904 as a decrease in test-year expense.

(11) **Taxes.**

(a) **Federal Income Tax.**

(i) **Petitioner's Position.** Petitioner calculated its pro forma federal income tax expense utilizing the Muncie Remand Method. This is a long-standing practice of Petitioner, which reflects the impact of its inclusion in a consolidated federal income tax return. The Muncie Remand Method allocates a portion of American Water's interest deduction to Petitioner for purposes of computing tax expense, thereby providing a tax benefit to customers. The interest allocated under this procedure was \$3,929,964 and this reduced tax expense by \$1,375,487.

(ii) **OUCC's Position.** Mr. Smith explained that Indiana-American is a participant in the American Water consolidated federal income tax return, and thus does not pay federal income taxes directly to the government. He added that when Indiana-American shows a positive current federal income tax obligation, it remits the money to American Water, which in turn may or may not remit an income tax payment to the federal government depending on the results of its consolidated federal income tax return. Based on the information available in the rate case, Mr. Smith said Indiana-American has not had an obligation to pay federal income taxes in recent years. Mr. Smith noted that any federal tax liability on the American Water consolidated return would be paid by American Water. Mr. Smith noted that Indiana-American's responses to OUCC 52-051(e) and (f) indicated that Indiana-American did not pay any 2009 federal income tax and did not expect to pay any 2010 federal income tax. However, in this rate request, Petitioner has reflected positive federal taxable income and positive current federal income tax expense. Mr. Smith noted that subsequent discovery responses provided by Petitioner indicate that American Water did not pay 2009 or 2010 federal income taxes and that it does not expect to pay 2011 federal income tax. Mr. Smith noted also that American Water reported in its 2010 Securities and Exchange Commission ("SEC") form 10-K that it had a federal NOLC in excess \$1.185 billion as of December 31, 2010, which grew from approximately \$1.124 billion as of December 31, 2009.

Mr. Smith noted the amounts that Indiana-American recorded on its books related to the American Water federal NOLC as of December 31, 2009 and 2010, respectively, are listed in the Company's confidential response to OUCC 52-039. Mr. Smith also noted that in another response Petitioner stated that based on current tax law, Indiana-American currently anticipates that American Water will pay alternative minimum tax in 2011. Mr. Smith stated that Indiana-American does not know if American Water will pay federal income taxes in any year, 2012 through 2015, but anticipates the parent company will pay only alternative minimum tax in each of those years. Mr. Smith noted that American Water did not pay federal alternative minimum tax in 2010. He added that Indiana-American stated no analysis has been done to project alternative minimum tax liability for 2011-2015." Thus, there is no reliable basis for concluding that American Water is likely to pay federal alternative minimum tax in any year in that period.

Mr. Smith noted that Indiana-American's income tax calculations for ratemaking purposes reflect that it would have positive state and federal taxable income. Thus, he noted Petitioner has included a positive amount for current state and federal income tax expense in its rate increase request. Mr. Smith noted that Petitioner has reflected a reduction to current federal income tax expense of \$1,375,487 related to a tax deduction for interest on parent company debt. Mr. Smith added that Petitioner determined the amount of its equity capital that was supported by American Water debt, and computed an interest deduction for the parent company debt of \$3,929,964, which Indiana-American multiplied by the 35% federal income tax rate to obtain the reduction to current income tax expense for parent company debt interest of \$1,375,487.

Mr. Smith advised that in a data request response, Petitioner explained that American Water does not allocate interest expense (or any other parent company expenses) to the operating companies for either book or tax purposes. For ratemaking purposes, Indiana-American advised in a discovery response that Petitioner uses the "Muncie Remand Method" to reflect the impact of participating in the consolidated federal income tax return. Mr. Smith noted language from the Commission's Order in Cause No. 37176 states as follows:

The Petitioner is a subsidiary of American Water Works Company, Inc. (AWW). As such it joins with AWW and other affiliated companies in filing a consolidated federal income tax return. Both the Petitioner and the Staff reduced the Petitioner's federal income tax expense allowable for ratemaking purposes by allocating a portion of AWW's interest expense to the Petitioner, thereby reducing taxable income. The same type of adjustment has been made in rate proceedings of other AWW subsidiaries. The method which was used was set forth by the Commission in its Supplemental Order on Remand dated September 16, 1981 in Cause No. 34571 involving Muncie Water Works Company. The Commission hereby takes administrative notice of the Supplemental Order on Remand in Cause No. 34571 and the methodology employed therein. The Commission finds and determine [sic] that such methodology accurately reflects the tax benefits resulting from the Petitioner's participation in the filing of a consolidated tax return, and should be used in this proceeding.

Indiana-American Water Co., 1983 Ind. PUC LEXIS 86, at *12-13 (Pub. Serv. Comm'n of Ind. Nov. 23, 1983).

Mr. Smith advised that the parent company interest deduction does not fully reflect the tax benefits resulting from Indiana-American's current participation in the consolidated income tax return. Rather, he noted it only reflects a sharing of the tax savings relating to the parent company interest deduction. To fully reflect the tax benefits from participation in a consolidated federal income tax return for ratemaking purposes, Mr. Smith stated it is necessary to make a consolidated federal income tax savings adjustment.

Mr. Smith explained that consolidated income tax savings adjustments are made in jurisdictions where Indiana-American's affiliates are regulated including Pennsylvania, New Jersey, and West Virginia. Of those, he was most familiar with the consolidated tax savings adjustments made in Pennsylvania and West Virginia, having participated in recent rate cases involving the American Water utility-operating subsidiaries in those states. Previously, a consolidated tax savings adjustment had also been made for the American Water utility-operating subsidiary in Kentucky; however, that adjustment was discontinued in the most recent Kentucky-American Water Company rate case.

Mr. Smith also discussed the impacts from filing a consolidated federal income tax return. Mr. Smith explained that the Consolidated Tax Savings Adjustment reflects the consolidated tax savings that result from Indiana-American's participation in a consolidated federal income tax return. Based on the four-year period, 2007 through 2010, Indiana-American had total positive federal taxable income of \$24,545,225, which was 6.0% of the total positive federal taxable incomes on the American Water consolidated federal income tax returns of \$409,318,033. During that period, the losses from non-regulated affiliate tax loss companies amounted to \$447,038,088. Mr. Smith noted Indiana-American's share of those, based on its 6.0% of total positive taxable income amounted to \$26,822,285, and the federal income tax benefit at the 35% statutory rate totaled \$9,387,800. He added that the average benefit over the four-year period to Indiana-American is \$2,346,950. Therefore, Indiana-American's share of the consolidated income tax savings are \$2.347 million. Mr. Smith explained that because a portion of the benefit of participating in a consolidated federal income tax return has already been

reflected by Indiana-American in its calculation of the parent company debt interest deduction, only the additional consolidated income tax savings above that amount are being reflected as an adjustment in the OUCC's calculation of current federal income tax expense. The net amount of consolidated tax savings adjustment is \$908,681.

Mr. Smith explained that Indiana-American computed federal income tax expense for the test period by applying a 35% federal income tax rate to the Company's determination of the test period's taxable income. He noted this is referred to as the "stand-alone" method, which assumes that the Company files a separate federal income tax return. Mr. Smith reiterated the fact that Petitioner reflected a deduction for parent company debt interest in computing its proposed current federal income tax expense for rate making purposes. He described that as the single exception to Indiana-American's use of a "stand-alone" or "separate return" method for computing its requested income tax expense for ratemaking purposes.

Mr. Smith noted Indiana-American does not actually file a separate federal income tax return. Rather, Indiana-American is part of the consolidated federal income tax return that is filed by American Water to minimize its federal income tax liability. Mr. Smith explained a consolidated income tax return generates tax savings because some members of the consolidated group generate tax losses, and these tax losses are used to offset a portion of the taxable income generated by the other affiliates, such as Indiana-American, to reduce income taxes payable for the entire consolidated entity. Mr. Smith noted that without a consolidated filing, it could take several years under the carry-forward and carry-back provisions of the Internal Revenue Code ("IRC") for recurring loss companies to fully realize tax savings. Without combining those recurring loss companies into a consolidated tax return with other companies that generate positive taxable income, such savings might not be realized. Mr. Smith testified that by filing a consolidated return, the consolidated entity, American Water, as a whole is able to realize, in the current tax year, the tax benefits generated by the loss companies.

Mr. Smith asserted that Indiana-American's ratepayers should share in the tax savings realized from the consolidated federal income tax filings. To that end, Mr. Smith stated that Indiana-American's ratepayers should only reimburse the Company for actual income taxes paid. He noted that if the tax savings from the consolidated income tax filings do not flow through to the Indiana-American ratepayers on an appropriate, proportionate basis, the ratepayers will pay rates that are higher than necessary to compensate Indiana-American for its actual costs. He therefore recommended that an appropriate consolidated income tax benefit be calculated for Indiana-American and reflected as a reduction to its current federal income tax expense in this case.

To calculate the consolidated income tax benefit adjustment for Indiana-American, Mr. Smith used the "effective tax rate" method, which is the exact same method that has been applied in the five Pennsylvania-American Water Company rate cases (four wastewater and one water) that Mr. Smith has participated in as an expert witness in the past two years. The only exception is that the calculation for Petitioner can include actual 2010 federal income tax results for American Water, which have become available as the result of American Water filing its consolidated federal income tax return for tax year 2010 by September 15, 2011. First, he considered the combined annual taxable income of all of the consolidated group members (including both regulated and non-regulated group members) with positive taxable income. He

examined the four years 2007 through 2010, obtaining information from Indiana-American's confidential response to OUCC data request 52-065, which listed the taxable income and tax losses each year for Indiana-American and each regulated and non-regulated affiliate that participates in the American Water consolidated federal income tax return. He then calculated for each year the ratio of Indiana-American's positive taxable income in that year to the total of all positive taxable income by consolidated group members. Next, he determined the combined annual taxable losses of all non-regulated group members for each year. Regulated group members with tax losses were not used in the analysis because such tax losses were not considered to be recurring events, and it is generally considered inappropriate to share the tax losses of a regulated utility with another regulated utility in a different jurisdiction. He then applied the Indiana-American ratio to the combined annual tax loss amounts from the non-regulated affiliates to arrive at the annual tax losses that should be allocated to Indiana-American in order to calculate Indiana-American's share of tax benefits produced by the consolidated income tax return filing. Finally, Mr. Smith applied the federal income tax rate of 35% to the average consolidated tax loss benefits allocated to Indiana-American. This calculation indicates a normalized consolidated tax savings benefit for Indiana-American of \$2,346,950 on a four-year average basis.

Mr. Smith explained that the calculation of the consolidated tax savings adjustment he derived for Petitioner is generally consistent with the derivation of the consolidated income tax savings adjustments in recent rate cases involving Indiana-American's affiliates in West Virginia and Pennsylvania, where consolidated tax savings adjustments have been made. For the Indiana-American calculation, the American Water consolidated federal income tax return for 2010 was filed by September 15, 2011; so, 2010 information is currently available, and he used it in the calculation shown on his Attachment LA-2, Schedule 2.

In the event that his proposed consolidated tax savings adjustment is not accepted, Mr. Smith proposed that an adjustment should be made to impute a domestic production deduction ("Section 199 Deduction"). He testified that, to the extent Indiana-American has positive federal taxable income on a separate return basis and otherwise qualifies, the Company would be eligible to claim a deduction under Section 199 of the IRC for domestic production activities. Because Indiana-American has its own water supply and treats the water, such activities qualify and would render Indiana-American eligible for the deduction if it has positive taxable income and meets the other requirements. He testified that, if his proposed consolidated tax savings adjustment is rejected and Indiana-American's current federal income tax expense is calculated primarily on a separate return basis, then the Section 199 Deduction should also be calculated on a separate return basis. Mr. Smith calculated a stand-alone Section 199 Deduction to be \$1,432,402 at Petitioner's proposed rates and \$1,079,763 at the OUCC's proposed rates.

Mr. Smith's final proposed adjustment for federal income taxes was to reduce current federal income tax expense by \$12,841 for the research and development credit based on Petitioner's discovery responses.

(iii) Petitioner's Rebuttal. Mr. Warren accepted Mr. Smith's research and development credit, but he opposed the consolidated tax savings adjustment and the Section 199 Deduction. He testified that, by adhering to the Muncie Remand Method, Petitioner properly reflected the benefits of its participation in a consolidated federal income tax return

under Indiana regulatory practice. He explained that the Muncie Remand Method was this Commission's specific attempt to address the proper ratemaking treatment for Petitioner's participation in a consolidated federal income tax return. In the Muncie Remand Order, the Commission determined that the tax savings from participation in a consolidated return were limited to the tax deduction taken by the parent company for its interest expense and rejected a method very much like that proposed by Mr. Smith. Mr. Warren testified that Mr. Smith's proposed adjustment is based on the tax results of the operations of non-regulated affiliates having nothing to do with the provision of regulated service to Indiana customers. Mr. Warren testified there were three major reasons for his disagreement with Mr. Smith's proposal. First, this Commission specifically considered and definitively rejected such a proposal in the Muncie Remand Method case. Second, his calculation is demonstrably one-sided. Mr. Smith imports tax losses from affiliates for the benefit of Indiana-American when Indiana-American has taxable income and the affiliates have tax losses. However, Mr. Smith does not export Indiana-American's tax losses to affiliates when Indiana-American has tax losses and those members have taxable income. Third, he believes it is neither economically justifiable nor equitable to reflect in ratemaking the tax consequences of expenses that are not, themselves, reflected in ratemaking. Mr. Warren testified that he knows of only four jurisdictions where consolidated tax savings adjustments are made. The only one that uses a method like that proposed by Mr. Smith is Pennsylvania - and that method was mandated by the Pennsylvania courts.

Mr. Warren further provided an example of why, philosophically, he opposes consolidated tax savings adjustments generally. If Indiana-American were to make a charitable contribution to a food bank, which is non-recoverable in rates, no party would contend that the benefit of the tax deduction for the charitable contribution should be allocated to ratepayers. However, under Mr. Smith's proposed consolidated tax savings adjustment, if an affiliate of Indiana-American made precisely the same charitable contribution, ratepayers could be allocated all or a portion of the benefit of that tax deduction. In his opinion, there is no justification for this inconsistency. Further, when a consolidated tax savings adjustment is imposed, the results of non-jurisdictional operations will have a direct effect on the setting of jurisdictional rates. A consolidated tax savings adjustment will reduce rates only if non-regulated affiliates produce tax losses. Conversely, if the Company's non-regulated affiliates begin to produce taxable income, the Company's revenue requirement will increase even if regulated operations do not change. Thus, decisions having tax implications that a non-regulated company makes in the normal course of business have the potential to impact customer rates.

As for the Section 199 Deduction, Mr. Warren testified that this is a very complex mechanism Congress enacted to provide a tax subsidy for certain domestic production activities. American Water presently does not qualify for a Section 199 Deduction - not because it does not engage in the requisite activities, but because the deduction is limited to consolidated taxable income. Largely due to bonus depreciation and the Repairs Method Change, American Water has no consolidated taxable income. Since the Section 199 Deduction is computed only on a consolidated basis, he testified that there is no deduction to allocate. Mr. Smith proposes to impute a tax deduction that does not exist in the tax law. Mr. Warren further explained that, even accepting, for the sake of argument, Mr. Smith's assertion that a commission could reasonably impute a Section 199 Deduction where it computes tax expense on a "stand-alone" basis, in Indiana, that is not the way tax expense is computed. The Muncie Remand Method is not a stand-alone approach to taxes but rather an attempt to account for the savings from

participation in a consolidated income tax return. He further had two disagreements with Mr. Smith's calculation of the Section 199 Deduction adjustment. First, Mr. Smith failed to take account of Indiana-American's stand-alone NOLC which must be absorbed before Indiana-American would qualify for a Section 199 Deduction on a stand-alone basis. Second, Mr. Smith would need to make assumptions that no party has made about deductions that will be taken on the tax return in years during which rates will be in effect in order to determine that Indiana-American would even qualify for the Section 199 Deduction on a stand-alone basis.

(iv) **Commission Findings.** As noted, Petitioner has accepted Mr. Smith's research and development credit adjustment, and we accept that portion of Mr. Smith's proposed adjustments. With respect to the proposed consolidated tax savings adjustment, we have previously determined that tax savings from participation in a consolidated return are limited to the tax deduction taken by the parent company on its interest expense. We use the following procedure to compute the parent company interest allocation: 1) compute the parent company's long-term debt to equity ratio; 2) multiply the Indiana utility's equity amount by the results of step 1; 3) calculate the parent company's average cost of long-term debt; and 4) multiply the results in steps 2 and 3. The result represents the interest expense on that portion of the parent company's debt that supports investment in the Indiana utility. The tax benefits of this amount should be allocated to the Indiana utility to determine its federal income tax expense for rate-making purposes. *Muncie Remand Order*, 1981 Ind. PUC LEXIS 246, at *37-38.

We have relied on this method for computing the benefits from participation in a consolidated federal income tax return for over thirty years. The precedent results from a remand from the Court of Appeals directing us to undertake such an effort. We continue to be concerned about the allocation to Indiana ratepayers of either the tax burden or the tax savings of out-of-state affiliated companies. The effect of the OUCC's proposed consolidated tax savings adjustment would be to change Petitioner's revenue requirement due solely to the activities of affiliate companies. Therefore, we reject the OUCC's proposed consolidated tax savings adjustment and adhere to the Muncie Remand Method.

We further reject the Section 199 Deduction adjustment because that adjustment assumes a stand-alone income tax expense calculation. Insofar as we continue to employ the Muncie Remand Method, we do not utilize a stand-alone calculation. As a result, it is inappropriate to impute the Section 199 Deduction on a stand-alone basis.

(b) **General Taxes.**

(i) **Petitioner's Position.** The Company proposed five adjustments totaling a \$1,130,374 increase to test-year general tax expense. The first was to payroll tax expense based on the pro forma level of wages. The second was to the Safe Drinking Water Act fee based on test-year accounts and rates. The third and fourth adjustments were for the IURC fee and utility receipts tax based on pro forma level of revenues. The final adjustment was to property taxes. Mr. VerDouw explained that property taxes were adjusted based on a calculation that starts with property taxes paid in 2010, determines the ratio of property taxes to total utility plant in-service on December 31, 2009, and applies that same ratio to utility plant in service on June 30, 2011, including the major project. The pro forma adjustment to property tax expense increased general taxes by \$768,267.

(ii) **OUCC's Position.** Mr. Patrick explained the OUCC's opposition to the property tax expense adjustment. Mr. Patrick noted that Petitioner's estimate of real and personal property taxes is based on estimated total utility plant on June 30, 2011. Mr. Patrick explained that property tax returns are filed on or before May 10 of each year based on the utility plant in service at the end of the prior calendar year or on February 28 of the current year. Mr. Patrick added that these returns are filed in each township within the county where the property resides. Mr. Patrick explained that utility plant in service added during 2011 will not be reported to the various county assessor offices until May 2012. He further explained that assessments for utility plant in service added during 2011 will not be assessed until late 2012 or 2013. Mr. Patrick noted that payment will not be made on property added in 2011 until 2013. Mr. Patrick added that tax assessments will be based on individual county budget requirements. Pursuant to the Commission's Prehearing Conference Order in this Cause, the adjustment period consists of the 12 months following December 31, 2010. As a result, Mr. Patrick rejected any adjustment from property taxes based on plant that would not be assessed before the end of the adjustment period or December 31, 2011. Accordingly, he computed a pro forma property tax expense adjustment of \$219,297 over the test year.

(iii) **Petitioner's Rebuttal.** Mr. VerDouw testified that Mr. Patrick's methodology has been rejected several times in prior Commission orders because it violates the matching principal. He testified that the level of property tax expense is to be matched to the approved rate base that produces the corresponding revenues. Mr. VerDouw testified that this corresponding "matching principle" has been used in every case that he has worked on for Indiana-American, and that until now it has never been disputed by the OUCC. Mr. VerDouw testified that Mr. Patrick's proposed methodology does not follow this precedent.

(iv) **Commission Discussion and Findings.** The parties agreed to an IDEM Safe Drinking Water Fee adjustment of \$11,157 as a decrease in test-year expense, and we accept the adjustment. The parties differing calculations of payroll tax stem directly from their disagreement on the level of labor expense. Based on our finding above that Petitioner's labor expense is \$17,021,654, we approve an increase of \$31,026 for a total pro forma payroll tax expense of \$1,257,784. Similarly, the parties disagreement over Environmental Tax, IURC Fee, Utility Receipts Tax, and State Income Tax were attributable solely to the different pro forma levels of revenue and net operating income. We approve those amounts as adjusted in light of the other findings in this Order.

With respect to property taxes, Petitioner cites prior Commission orders to support its argument that Mr. Patrick's approach, which removed property tax expense for property not assessed in the adjustment period, violates the matching principle and is inconsistent with our past decisions. In *Midwest Natural Gas Corp.*, we addressed a similar situation. Cause No. 39097, 1991 Ind. PUC LEXIS 352 (IURC Nov. 1, 1991). The utility sought to include an expense adjustment for recently constructed plant. *Id.*, at *25-27. The Property had been assessed in March 1991, which was during the pro forma period following the test year. *Id.* Therefore, we found that the adjustment was fixed, known, and measurable, and we included the adjustment in the utility's property tax expense. *Id.*

We addressed a similar situation in *Ind. Cities Water Corp.*, Cause No. 39166, 1992 Ind. PUC LEXIS 215 (IURC Jul. 8, 1992). The utility sought to include an adjustment for plant

added between December 31, 1990, and May 31, 1991. *Id.*, at *28-33. The test year in that case ended June 30, 1990, with a 1-year adjustment period. The new plant was assessed for tax purposes on March 1, 1991. *Id.*, at *28. The utility's witness admitted that the tax rate would not be set until 1992, and the taxes would not be due until 1993. *Id.* However, he explained that the utility's accrual accounting system records property taxes as a liability in the year of assessment, i.e. during the adjustment period. The utility estimated the property tax expense based on the most current tax rate. *Id.* The OUCC argued that the expense was not fixed, known, and measurable because the tax rate was not known within the test-year adjustment period. *Id.*, at *31. The Commission included the utility's proposed expense for new plant, finding that estimating the property tax using the most-current tax rate and an assessment made during the adjustment period resulted in a sufficiently fixed, known, and measurable expense. *Id.*, at *33.

In both *Midwest Natural Gas* and *Ind. Cities Water*, the Commission relied on an assessed value that occurred during the adjustment period. That is not the case here. Petitioner asks us to include property tax expense for property that will not be assessed until 2012, and will not be payable until 2013. In *Lincoln Utils., Inc.*, the Commission denied an adjustment to include property tax expense on new plant, finding that the property would not be assessed until after the adjustment period ended. Cause No. 38169, 1990 Ind. PUC LEXIS 44, at *14 (IURC Feb. 14, 1990). The Commission concluded the expense was not fixed, known, and measurable. *Id.* Similarly here, we conclude that Petitioner's proposed adjustment for property tax expense on new property that was not assessed during the adjustment period is not fixed, known, and measurable, and we accept the OUCC's deduction of \$219,297 from total property tax expense.

Based on our findings above, we conclude that Petitioner's total pro forma General Taxes Expense is \$15,257,962, which is an increase of \$489,644 from the test year.

10. Net Operating Income at Present Rates. Based on the evidence and the determinations made above, we find Petitioner's adjusted operating results under its present rates are as follows:

Operating Revenues		\$ 196,426,042
Operating & Maintenance Expenses	73,904,211	
Depreciation and Amortization Expens	35,367,373	
Taxes Other than Income	15,257,962	
State Income Tax	5,229,715	
Federal Income Tax	16,283,049	
Total Operating Expenses		<u>146,042,310</u>
Net Operating Income		<u><u>\$ 50,383,732</u></u>

In summary, we find that with appropriate adjustment for ratemaking purposes, Petitioner's annual net operating income under its present rates for water/sewer service would be \$50,383,732. We have previously found that the fair value of Indiana-American's utility property is \$1,051,885,770, and a fair return on that property is \$51,509,986. Petitioner's current return of \$50,383,732 is insufficient to represent a fair return on the fair value rate base. We therefore find that Petitioner's present rates are unreasonable and confiscatory.

11. **Authorized Rate Increase.** On the basis of the evidence presented in these proceedings, we find that Petitioner should be authorized to increase its rates and charges to produce additional operating revenue of \$1,948,284, a 1.00% increase in water/sewer revenues, resulting in total annual operating revenue of \$198,374,326. This revenue is reasonably estimated to afford Petitioner the opportunity to earn a net operating income of \$51,509,986, as follows:

Operating Revenues	<u>\$198,374,326</u>
Less: O&M Expenses	73,927,146
Depreciation/Amortization	35,367,373
Other Taxes	15,287,154
State Income Tax	5,393,176
Federal Income Tax	<u>16,889,491</u>
Total Expenses	<u>146,864,340</u>
 Net Operating Income ("NOI")	 \$ 51,509,986
Less: NOI at Present Rates	<u>50,383,732</u>
 Increase Required	 \$ 1,126,254
Times: Revenue Conversion Factor	<u>1.72988</u>
 Authorized Increase in Revenue	 <u>\$ 1,948,284</u>
Revenue Percent Increase	<u>1.00%</u>

12. **Cost of Service Study and Rate Design.**

(a) **Petitioner's Position.** Mr. DeBoy sponsored Petitioner's proposed rate design for this case. He testified that the Company is proposing to move closer to full STP in this case. He provided a history of the gradual move the Company has been making to full STP over the course of 14 years. In the last rate case, the Company proposed and was granted authority to consolidate to full STP except for volumetric rates for retail general water service, for which there are currently two groups. Area Two includes the former United Operations and Wabash. Area One includes everything else. In this case, Petitioner proposes to move West Lafayette and Warsaw to Area One and to move Area Two closer to Area One rates.

He also testified concerning Petitioner's proposal for public fire protection. The Company proposed to roll the public fire protection surcharge costs into the customer charges. What was formerly included in the direct-billed public fire protection surcharge rates would, under Petitioner's proposal, be included in the customer charges for purposes of billing all customers on a single-tariff basis. In addition, Mr. DeBoy explained that the Company is proposing to eliminate public hydrant charges by directly recovering public fire protection costs from all customers by meter size. This would include those remaining municipalities that have not adopted an ordinance pursuant to Ind. Code § 8-1-2-103. He noted that customers in unincorporated areas within 1,000 feet of a hydrant are already paying the surcharge by meter size without any ordinance being adopted. He testified that letters had been sent to all mayors in the municipalities that have not previously adopted the Ind. Code § 8-1-2-103 ordinance, explaining that any municipality that wished to be withdrawn from this request and continue paying hydrant charges would have its wishes honored if they simply inform the OUCC or

Indiana-American prior to the close of the record in this case. He indicated that Petitioner would supplement its rebuttal testimony with any requests received prior to the close of the record.

Mr. Heid testified concerning Petitioner's Cost of Service Study and Rate Design. He also provided a history of the Company's movement towards STP, beginning with the 1997 Rate Order. The Company then continued a phased approach towards STP in its next several rate cases, Cause No. 41320, 42029 and 42520. Pursuant to the 2007 Rate Order, Petitioner increased its rates on an across-the-board basis. Then in the 2010 Rate Order, Petitioner was authorized to make a significant move towards STP. In this proceeding Petitioner proposes to move two of its Area Two districts into Area One, reduce the differential between Area One and Area Two commodity charge, and roll the public fire protection rates into the customer charges on a meter equivalency basis.

Mr. Heid conducted and presented a Cost of Service Study ("COSS"). He stated that the basic premise in establishing fair and equitable rates is that rates reflect the cost of providing service to each customer class and that a COSS is the tool used to make this determination. The purpose of the COSS is to allocate the total cost of service to each customer class. Mr. Heid used the AWWA Base-Extra Capacity method to allocate costs to customer classes. He testified that this method has been widely used and accepted in Indiana and elsewhere. Under the Base-Extra Capacity method, Petitioner's revenue requirements are allocated to the following cost functions according to the design and operation of the water system: base, extra capacity, customer, and direct public fire protection costs. These functionalized costs are then allocated to each customer class according to its usage and demand characteristics and other factors. Base costs are those costs that vary directly with the total quantity of water used as well as those costs associated with serving customers under average load conditions. Extra capacity costs are costs incurred due to demands in excess of average load conditions. Customer costs tend to vary in proportion to the number of customers. Direct public fire protection costs include the cost for maintaining and flushing public fire hydrants and the costs associated with those hydrants.

He testified that the total base costs are allocated to customer classes based on each customer class's average-day demand compared to the total average-day demand of all customer classes. Costs associated with facilities designed to meet peak demands are assigned to the maximum-day cost function. The total maximum-day costs are allocated to customer classes based on each customer class's maximum-day demand compared to the total maximum-day demand for all customer classes. Costs associated with facilities to meet peak hour demands are assigned to the maximum-hour cost function, which are allocated to customer classes based on each customer class's maximum-hour demand compared to total maximum-hour demand. Customer costs are directly assigned to their respective cost functions, either billing related or meters related.

He testified that there is also a need to differentiate the use of facilities between small volume and large volume users. In this expansion of cost categories, costs assigned to the basic cost functions (base and extra capacity) are further classified as common to all customers or common to small customers. As an example, sale-for-resale customers and very large volume industrial customers tend to be served from transmission mains and do not use the distribution mains. Smaller customers, on the other hand, are served by both the transmission mains and the distribution mains.

Mr. Heid testified that the water system is comprised of various facilities, each designed and operated to fulfill a given function. The system must be capable of providing not only the average annual amount of water used, but also supplying water at maximum daily and hourly rates of demand. Since all customers do not exert maximum demands at the same time, capacities of the various system facilities are established to meet the maximum coincident demand of all classes of customers. The maximum-day and maximum-hour coincident demand ratios were determined from an analysis of historical recorded average-day, maximum-day, and maximum-hour rates of water deliveries to the system. Mr. Heid relied on Petitioner's comprehensive planning reports for purposes of conducting this analysis. His analysis indicated that the maximum-day coincident demand is 1.54 of the average-day demand and the ratio of system maximum-hour coincident demand to average-day demand was determined to be 2.25. In Petitioner's Exhibit KAH-2: Schedule 1, presents the derivation of the maximum-day and maximum-hour functional cost allocation factors; Schedule 3, shows the allocation of the rate base to the various cost functions; Schedule 4, presents the allocation of depreciation and amortization expense; Schedule 5, shows the allocation of operation and maintenance expense; Schedule 6, presents the allocation of taxes; and Schedule 7, presents the allocation of miscellaneous revenues and credits.

Mr. Heid testified that the next step in the process is to allocate each of the functional costs to customer classes based on the respective cost responsibilities of each customer class. This is accomplished by determining each customer class's relative volume, extra capacity requirements, bills, and equivalent meters. These are commonly referred to as units of service. Petitioner's Exhibit KAH-2, Schedule 9 shows the customer classes along with their respective units of service. This schedule also shows the maximum-day and maximum-hour capacity factors for each customer class respectively. He testified that for purposes of this proceeding he used the capacity factor percentages that have been used for several cases now. He testified that each customer class's relative maximum-day and maximum-hour rates of use serve as the basis for allocating maximum-day and maximum-hour capacity-related costs to customer classes. The rationale for this is that customers with a high peak rate of use as compared with an average rate of use require larger capacity pumps, mains, and certain other system facilities than a customer who has the same total volume of use but takes water at a uniform rate. Maximum rates of use are expressed in terms of a capacity factor. Thus, if a customer class maximum-day rate of use is 2.0 times its average rate it is said to have a maximum-day capacity factor of 200%.

Mr. Heid testified that in Cause No. 43680, the Commission found that the Company should conduct and present a new capacity factor analysis in this case. He did so utilizing the methodology set forth in the AWWA Water Rates Manual, Fifth Edition (the "AWWA Rates Manual") and it was contained in his workpapers. He recommended that the COSS not be based on these capacity factor percentages because the results were surprising to him and were not reasonable. He testified that the residential and commercial capacity factors derived by his study were extraordinarily low and were not reasonable. He instead designed rates based on the previous capacity factor percentages that have been used for many cases. He testified he did so rather than implement the significant shifts among rate classes that would be called for from the new capacity factor analysis and needing to reverse those shifts should later studies prove these results to be an anomaly. He explained the difficulty with respect to performing a capacity factor analysis based solely on the AWWA Water Rates Manual methodology. The capacity factor analysis seeks information pertaining to customer class peak day and peak hour information.

However, the sole source of data to review capacity factors are monthly and bi-monthly meter reading and billing records. This requires Mr. Heid to estimate customer class peak and peak day and peak hour capacity factors using the methodology outlined in the AWWA Rates Manual. On completing the estimation, certain tests of reasonableness are performed to determine whether the allocation factors are within a reasonable range. The AWWA Rates Manual recommends that a system diversity ratio be computed and the ratio should be in the range of 1.10 to 1.40. He calculated the diversity ratio from the new analysis to be 1.13 for both the maximum-day and maximum-hour. Given the extreme proximity of this diversity ratio to the bottom end of the range of reasonableness, he found the results to be troubling, confirming his concern about the unreasonableness of the capacity factors developed utilizing the AWWA Water Rates Manual. As such he used the capacity factors that had been in use for many cases now but recommended to the Petitioner that a much more in-depth capacity factor study be developed for use in its next rate case. He recommended that the Company continue to study and review capacity factors over a longer period utilizing a more sophisticated and accurate methodology than set forth in the AWWA Water Rates Manual. For example, Mr. Heid recommended that the Petitioner consider utilizing load research by installing load research meters on a statistically valid sample of customers, an approach that is unprecedented for a water utility in Indiana.

Mr. Heid testified that the next step in the COSS is to calculate the unit cost of service for each cost function. Petitioner's Exhibit KAH-2, Schedule 12, shows this computation. Unit costs provide a means of distributing costs to the customer classes based on their respective service requirements. Unit costs of service are instrumental in rate design. Petitioner's Exhibit KAH-2, Schedule 13, shows the application of the unit costs of service to the units of service for each customer class to determine the total cost of service for each class. Petitioner's KAH-2, Schedule 14, compares the customer class revenues under current rates to the customer class costs of service computed in this fashion. The overall average increase to the customer classes, based on Petitioner case-in-chief filing, is 10.72%, so any customer class requiring less than a 10.72% increase to reach cost of service is providing a subsidy. Those requiring more than a 10.72% increase are receiving a subsidy. He noted that Indiana-American is proposing to moderate certain of the significant rate impacts.

Having completed the COSS, Mr. Heid then discussed the proposed rate design. He explained that the Company hoped to move completely to STP in Cause No. 43680. However the rate impacts in Mooresville, Warsaw, West Lafayette, Winchester, and Wabash would have been unacceptably large. This is a result of those operations having very low tail-block rates, which began at a low monthly usage level. This led to the creation of Area One and Area Two tariff rates. In this proceeding, Warsaw and West Lafayette would be transferred to Area One tariff rates leaving only three districts in Area Two tariff rates. In Petitioner's next rate case, its objective would be to move completely to STP or, as in this case, reduce the differential between the area rates. In addition, the Company is also proposing, consistent with the 2010 Rate Order, that future changes in DSIC be implemented on a STP basis.

Petitioner's Exhibit KAH-3, Schedule 1, presents the calculation of the proposed monthly and bi-monthly customer charges, prior to the addition of public fire protection surcharges. He noted that all customers would be subject to the same schedule of customer charges. Mr. Heid then described how the commodity charges were calculated for each class. In developing Area

One and Area Two commodity charges, he considered the stand-alone impacts for the Area Two districts. To the extent practicable, he attempted to keep bill impacts below the level of the stand-alone percentage increases. Since Area Two rates for Mooresville, Winchester, and Wabash were the critical rates causing the need for bifurcation of the commodity charges, his initial focus was on establishing Area Two commodity charges. He then designed the Area One commodity charges. Mr. Heid proposed the continuation of a declining block rate structure for retail general water service, which is designed so that each of the four retail customer classes recovers its respective costs of service. Industrial and large industrial reach the larger volume blocks so that rates are appropriately designed for those classes.

The sales-for-resale customer class has its own classification, which utilizes a single block rate structure. Mr. Heid proposed revisions to Petitioner's existing tariff for sale-for-resale standby service. Petitioner's Exhibit KAH-3, Schedule 4 contains the derivation of this rate.

Mr. Heid then described the calculation of proposed fire protection charges. Petitioner's Exhibit KAH-3, Schedule 3, provides calculation of rates for fire service both public and private. Public fire protection surcharge rates were derived based on meter size. He also testified that Indiana-American is proposing to moderate the impacts on public fire protection increases.

With respect to sewer service, Petitioner proposed to design the sewer rates at the same level as previously approved in the 2010 Rate Order. This would recover approximately \$112,000 less than the sewer revenue requirement, which would be recovered through water rates. Mr. Heid testified that if this proposal was not acceptable, sewer customers would pay a monthly residential rate of \$80.94 rather than the current \$61.29 per month. The average residential water customer would experience an increase of slightly more than 3¢ per month to accommodate this proposal.

(b) OUCC's Position. Mr. Dahlstrom testified that the OUCC strives, where possible, to base its COSS and Rate Design on the methodologies identified in the AWWA Rates Manual. In addition, the OUCC aims to develop cost-based rates. Mr. Dahlstrom's COSS followed the Base-Extra Capacity method, as spelled out in the AWWA Manual. Mr. Dahlstrom testified regarding the OUCC's three primary goals in developing a COSS and rates. The first goal is to propose rates that are fair, equitable, and cost-based, and that eliminate subsidies where possible. The second goal is achieving consistency in cost functionalization, allocation, and rate design. Third, new rates should not produce rate shock for customers when implemented.

Mr. Dahlstrom testified that he had concerns with the functional allocation of costs in Mr. Heid's COSS. He testified that one of his major concerns with Mr. Heid's allocation of costs to the various functions is the mismatch in updating some, but not all, of the allocation factors, with test-year data. Mr. Dahlstrom said there are two main functional allocation percentage factors used in both Mr. Heid's and the OUCC's cost of service studies. Those are the Maximum-Day/Average-Day (Max Day) factor and the Maximum-Hour/Average-Day (Max Hour) factor. Mr. Dahlstrom testified that in Mr. Heid's model, Mr. Heid updated the Max Day factor, but not the Max Hour factor. When asked to provide support for the two factors used in Mr. Heid's study, Petitioner responded by providing support for the Max Day factor only.

Indiana-American said they did not have support for the Max Hour factor, but they were simply using the factor used in the two previous Causes.

Mr. Dahlstrom stated the AWWA Rates Manual, on page 299, discusses the fact that Max Hour factors build on the determination of the Max Day factors. He said the strong relationship between the two factors indicates it would not be appropriate to consider the two factors in isolation, as Petitioner has done. Mr. Dahlstrom testified that the AWWA Rates Manual indicates, in the Base-Extra Capacity method of Functional allocation, that the analyst can choose to subdivide these costs between Max Day and Max Hour functions. Mr. Dahlstrom said Mr. Heid selected this option when developing Petitioner's COSS. Mr. Dahlstrom testified that subdividing these costs indicates using two related factors, not factors based on two different sets of input data. Mr. Dahlstrom testified Petitioner has used one factor based on historical data far outside the test year. Further, Petitioner provided no documentation on the derivation of its historical Max Hour factor.

Mr. Dahlstrom testified that he used functional percentage factors based on test-year information, for both allocators. He said this yields the most reasonable and fairest rates, because it most closely matches current conditions. Inconsistently updating only one of the functional allocation percentage factors, not both, yields unfair and unreasonable results. Mr. Dahlstrom said Mr. Heid used test-year sales, customer counts, expenses, and numerous other test-year data. Mr. Dahlstrom said it was inconsistent that Mr. Heid would not update both functional percentage allocation factors using test-year data, when Mr. Heid used test-year data in calculating almost every other factor in Petitioner's COSS and rate design in this Cause.

Mr. Dahlstrom was also critical of Mr. Heid's allocation of costs to functions. Mr. Heid had allocated costs associated with mains that are 2-inches and smaller directly to the customer function. Mr. Dahlstrom testified that only those costs that would be avoided if a customer leaves the system, such as meters, services, meter reading, and customer service/accounting should be used in the derivation of the monthly customer charge. He cited as support Citizens Gas & Coke Util., Cause No. 42767, p. 76 (IURC Oct. 19, 2006). He testified that in Petitioner's last case, Petitioner did not include any allocation of mains to the customer function, but that in prior cases, Petitioner had included an allocation of mains 4 inches and smaller to the customer function.

Mr. Dahlstrom then addressed allocation to customer classes. He testified the major driver in allocating costs to customer classes is the capacity factor. He testified that the capacity factors used in Mr. Heid's study had been developed some time in the past and that there is no current support for them. He testified that the use of old capacity factors is inappropriate pursuant to the AWWA Rates Manual and suggested the capacity factors need to reflect the most recent five years of data. Mr. Dahlstrom used the newly updated capacity factors created by, but not used by, Mr. Heid. Mr. Dahlstrom testified that using these factors represents the most recent data available on customer demands and it is his preference to use test-year data, where possible, in his COSS.

Mr. Dahlstrom said that in addition, using test-year based data is consistent with the majority of other data used in his COSS. He said his data includes, but is not limited to, test-year sales, test-year customer counts, test-year assets, test-year expense, test-year billing

determinants, and test-year functional-percentage allocators. Mr. Dahlstrom testified these test-year Capacity Factors, while different from the old Capacity Factors Petitioner has used, meet the same Calculation of Diversity Factor reasonableness test discussed on pages 22 and 23 of Mr. Heid's testimony and which are explained further on page 300 of the AWWA Rates Manual.

Mr. Dahlstrom also criticized Mr. Heid's equivalent meter factors analysis, which was based on the costs of various size meters. Mr. Dahlstrom noted that in testimony at the hearing, Mr. Heid discussed that his analysis was not based on actual meter costs. Mr. Dahlstrom also noted that Mr. Heid discussed that the reference to cost in his written testimony was for explanatory purposes. Mr. Dahlstrom testified Petitioner was unable to provide an explanation on how the equivalent meter factors in this Cause were calculated.

Mr. Dahlstrom said equivalent meter factors are used to allocate customer function costs to the various customer groups and are ultimately used in the calculation of the monthly customer charges for each meter size. Therefore, using known and current data is the best way to allocate these costs. Mr. Dahlstrom testified that since this information is unavailable, the OUCC proposes to keep the monthly customer charges at their current levels. Mr. Dahlstrom recommended that in Petitioner's next rate case a new equivalent meter study be conducted.

With respect to rate design, Mr. Dahlstrom proposed to reduce subsidies to move towards cost-based rates. He testified Petitioner's proposed rate design creates an artificial subsidy for each of its customer classes with the residential customers subsidizing industrial and sale-for-resale customers, by as much as 12%. He said, as a result, Petitioner's rate design assigns an inappropriate share of its proposed rate increase to the residential customers. Mr. Dahlstrom testified the OUCC's COSS more appropriately allocates, in accordance with the AWWA Rates Manual, the revenue requirements, including any increases, among all customer classes, based on the cost to provide service to the individual customer classes, and thus minimizing any inter-class subsidies.

Mr. Dahlstrom testified there are special challenges to overcome in this Cause regarding rate design. Mr. Dahlstrom said currently, Indiana-American has two sets of residential commodity rates. One residential rate is for Indiana-American's Area-1 customers. The other residential rate is for its Area-2 customers, whose rates are currently lower than those in Area-1. He noted Petitioner has proposed, as it has in previous Causes, to continue its plan to move all residential customers toward STP.

Mr. Dahlstrom testified regarding his concerns with the way Petitioner has proposed the continued move to STP in this Cause. He said his main concern is the inconsistency in which Petitioner is proposing to move various Area 2 customers to STP. He said Petitioner has proposed moving two of the five current Area 2 districts to STP rates, while the remaining three Area 2 customers continue to pay lower commodity rates. Mr. Dahlstrom testified that under Petitioner's proposal, West Lafayette and Warsaw customers will see their commodity rates increase from between 75% to 88% when moved to STP. Mr. Dahlstrom said commodity rates for the remaining Area 2 customers will see commodity rate increases of 33% for the first block and 41% for the second block. Mr. Dahlstrom testified that he is concerned with the rate shock that West Lafayette and Warsaw customers would see under Petitioner's proposal. He said Petitioner's proposed commodity rate increase is on top of an almost 25% increase in the

proposed monthly customer charge, which equates to an annual increase of over \$58 dollars per residential customer.

Mr. Dahlstrom noted the OUCC has filed for an overall reduction in the revenue requirement and the resulting rates in this Cause. He said that with this reduction in revenue requirement and based on the OUCC's COSS allocations, he was proposing rates that complete the move to STP for all residential customers. The Commission's final determination, as to the total revenue requirement allowed and COSS allocations approved, will influence the amount of movement to STP possible and any potential rate shock in this Cause. Mr. Dahlstrom said, in addition, he is proposing rates that will produce substantially lower subsidies than the subsidies proposed by Petitioner.

Mr. Dahlstrom said if the Commission approves anything other than the OUCC's proposed revenue requirement and COSS, then a subdocket may be the best way to approach rate design in this Cause. He said the wide difference in the revenue requirement being proposed by the two parties, the wide divergence in COSS methodologies between the Petitioner and the OUCC, and the fact Petitioner's COSS does not tie to its filed revenue requirement, complicates the development of any rates. On cross-examination, Mr. Dahlstrom agreed that pending resolution of the subdocket, rates would be modified on an across-the-board basis.

Mr. Dahlstrom also had concerns regarding Petitioner's proposed monthly customer charge. He stated Petitioner has inappropriately allocated mains and related costs to the customer function. This misallocation has overstated the customer function costs and the resulting monthly customer charge. Mr. Dahlstrom said his allocations justify a much lower monthly customer charge – even lower than Petitioner's current monthly commodity charges. However, he proposed to maintain the current level of monthly customer charges for all customers in this Cause.

Mr. Dahlstrom testified in opposition to Petitioner's public fire protection proposal. He opposed moving the eight remaining municipalities that have not adopted an ordinance pursuant to Ind. Code § 8-1-2-103 to a surcharge by meter size. Ms. Stull also opposed the inclusion of the fire protection rates within the base charge because doing so would cause Petitioner's customers to be subject to additional sales tax.

Mr. Dahlstrom objected to Petitioner's proposal with respect to sewer rates. He testified that he could not identify the level at which sewer rates are currently being subsidized and suggested that further study is needed. He did ultimately recommend that until the subsidies can be determined current sewer rates be maintained. He proposed a COSS be conducted for sewer service. Mr. Dahlstrom testified this study should determine the amount sewer rates are being subsidized by water customers and Petitioner should use this information in making a proposal to move sewer rates to cost-based rates sometime in the future.

(c) West Lafayette's Position. Mr. Krohn provided the position of West Lafayette on rate design. He testified that Petitioner acquired the West Lafayette system in 2000. After the 2002 Rate Order, a typical residential customer would have paid \$15.52 per month. After the 2004 Rate Order, that customer paid \$17.57. After the 2007 Rate Order the rates went to \$19.52. And after the 2010 Rate Order, the typical residential customer in West

Lafayette increased to \$27.10, which was roughly a 39% increase over the prior rates. He testified that the cumulative increase in rates for West Lafayette residents from the fourth quarter of 2002 to the second quarter of 2010 amounted to approximately 75%.

In this case, the proposed increase for West Lafayette would increase the average bill by an additional 62%, taking the cumulative increase to more than 182%. Mr. Krohn believes that the Commission should consider the history of rate increases when evaluating the economic impact of Petitioner's proposal. He cited to Cause No. 43645 where the Commission held that to impose a rate increase in excess of 50% on both the industrial and resale customers on top of a recent 10.8% increase would be excessive and should be mitigated.

He compared West Lafayette's rate increases to various consumer price indices over this period. He suggested that the attempt to reduce the subsidy between Area One and Area Two rates in a manner that accelerates the elimination of a subsidy to West Lafayette customers over what is in essence a two-year period is drastic and results in rate shock. He proposed that West Lafayette be left in Area Two rates and moved to full STP rates along with the other Area Two districts in future cases and that the proposed rate increases for Area Two districts should be modified so that no district experiences an increase that is greater than 50% or greater than two times the system-wide average increase. In the event this proposal was unsuitable, he proposed that the West Lafayette district be moved into an intermediate rate area and moved to full STP in future cases and that this same restriction of no increase greater than 50% or greater than two times the system-wide average increase be applied to West Lafayette.

(d) Crown Point's Position. Mr. Guerrettaz described the Crown Point system and plant. He described the contract between Crown Point and Petitioner whereby Petitioner is to provide up to 6 million GPD at a maximum flow rate not to exceed 4,170 gallons per minute ("GPM"), with provisions for increasing maximum flow up to 8 million GPD. He described the system's two pressure zones including Crown Point's five water storage facilities that total six million gallons of water storage. He described the system's two pumping stations with five high capacity pumps. He testified that the system is designed so that it can minimize burdens on Petitioner's system but that design capability was not considered in Petitioner's COSS. He testified Crown Point's six million gallons of storage meet additional demands on Crown Point's system from main peak times and fire events without impacting Petitioner's system.

Mr. Guerrattaz criticized Petitioner's proposed capacity factors as outdated and proposed that the capacity factors prepared by Mr. Heid be modified. He proposed changing the sale-for-resale maximum-day capacity factor to 120% and the maximum-hour capacity factor to 160% to be in line with industrial large customers. He testified that Crown Point's demands and flows are more similar to the large industrial class. He cited the water supply agreement with Indiana-American which limits maximum flow to Crown Point and Crown Point's substantial water storage facilities as a means of limiting demands on Petitioner. He provided the range of reasonable max day and max hour capacity factors as shown in the AWWA Rates Manual, which shows his proposed factors are within the range of both Industrial and wholesale customers

Mr. Guerrettaz explained that the 3 million gallon storage facility near Crown Point's intake pipe from Petitioner's system was designed and financed in 1997 when the water supply

contract was first negotiated between Crown Point and Petitioner's predecessor Northwest Water. He explained that there was considerable discussion between the parties intended to moderate Crown Point's demands on Northwest's system resulting in the addition of the 3 million gallon storage facility. He emphasized the Petitioner's COSS does not reflect the limitation on flows, the substantial storage facilities and the manner of system operations, all intended to limit water demands on Petitioner's system.

He quoted from the AWWA Rates Manual to support his proposed maximum-day maximum-hour factors for Crown Point and sale-for-resale customers, which gives the example of a wholesale utility purchasing water to recharge a water storage facility. Allowing the storage tank elevation to rise or fall with demand of end-use customers, the wholesale customer's demand profile may more resemble that of a large industrial customer and can actually result in reducing the maximum-hour demand placed on the water supplier.

Mr. Guerrettaz testified that an option that would be fairer to Crown Point and achieve his proposed revenue allocations is a two-tier, declining-block rate similar to what Petitioner proposed for other large volume customers. He cited sections of the AWWA Rates Manual to support his request for a declining-block rate structure.

Mr. Guerrettaz expressed concern regarding the allocation of transmission and distribution mains in Mr. Heid's study. He testified no comprehensive study of main size exists creating a lack of evidence to support 12-inch mains allocated to sale-for-resale customers. He also expressed concern regarding the allocation of mains that are unidentified by size to sale-for-resale customers.

Crown Point also submitted cross-answering testimony. Mr. Guerrettaz testified the OUCC recommendation that Petitioner's rates be reduced presents an opportunity to properly align rates while mitigating rate and STP impacts on the various classes and divisions. Mr. Guerrettaz generally agreed with many of the concerns of Mr. Dahlstrom and also requested a subdocket be created for rate design. He objected to Mr. Dahlstrom's proposed use of the test-year capacity factors, testifying he doubts that either Mr. Dahlstrom's or Mr. Heid's capacity factors are correct. He opposed Mr. Dahlstrom's treatment of sale-for-resale customers in his COSS and rate design.

Mr. Guerrattaz testified that Mr. Dahlstrom has proposed a monthly service charge, volumetric charge, and demand charge for sale-for-resale customers and he opposed such charges. He testified Mr. Dahlstrom's treatment of sale-for-resale customers does not recognize that some, like Crown Point, have utility plant, storage, and operating practices that minimize peak demands, while other sale-for-resale customers do not. To properly recognize the diminished demands that Crown Point and potentially other sale-for-resale customers may place on Petitioner's system, it would be appropriate to have a second set of rates for customers that have plant and operating practices necessary to minimize demand or shift demand to off peak periods.

He testified Crown Point currently sets its intake valve to meet average flows, not peak flows because it relies on its robust storage to meet peaks. This allows Crown Point to avoid the sharp peak consumption spikes that are commonly attributed to residential customers during

peak summer hours and on hot days. Crown Point's diverse commercial and industrial customer load of 9,739 residential, 786 commercial, and 49 industrial customers further reduces peak demands. Crown Point's ability to control its water intake and reliance on storage can make its demand more like an industrial customer rather than residential. He pointed out however, that the Company's proposed sale-for-resale rates, that Mr. Dahlstrom apparently accepts, treat Crown Point worse than if they were just a single, huge residential or industrial customer by denying it a lower cost declining block rate, like the lower cost third block of the General Service Rate applicable to all other customers.

Mr. Guerrettaz provided a discovery response from Petitioner, in which Petitioner indicated it is erroneous to assume that sale-for-resale rates could be separated into two sets of STP rates, one for those that can control or shift peak use and one for those that cannot. Instead, to recognize cost drivers in those customers would not result in two STP sets of rates but rather in separate rates for each individual sale-for-resale customer. He testified it is incongruent for Petitioner to argue the cost of service to each sale-for-resale customer is so different as to require a separate rate while at the same time Petitioner opposes even a second sale-for-resale rate that would allow some sale-for-resale customers that can shift demand to be closer to their lower cost of service. He testified Petitioner's position incorrectly indicates that we are better off staying with a single sale-for-resale rate that does not recognize or promote peak avoidance or reduction rather than fashioning a simple second rate e.g. with lower capacity factors and a declining block that more closely matches cost of service and encourages management of peak hour demands. He pointed out the incongruity that Petitioner charges customers for the Wise Water Program to survey select municipalities about water conservation and to spread well-known messages, promoting residential water conservation and asks for accelerated rate recognition of declining residential customer use from conservation; yet, Petitioner will not even consider a simple second STP sale-for-resale rate that would give large volume municipal customers rate recognition for their ability to minimize or shift peak consumption levels. He indicated that implementation of such a rate might encourage and make financially feasible other sale-for-resale customers to add plant, programs, and operations needed to participate in peak reduction.

Mr. Guerrettaz testified that the AWWA Rates Manual is not like a book of set chemistry formulas intended to always reach the exact same results. The manual offers the cost of service study artisan situational specific flexibility within reasonable parameters and helps define those parameters. Mr. Guerrettaz quoted several excerpts from the AWWA Rates Manual that support the application of declining block rates to sale-for-resale customers. Some of these excerpts also acknowledge that the diversity of customers served by sale-for-resale customers translates into a more uniform demand on the supplying utility and that system costs decline with economies of scale e.g. spreading fixed costs over more sales units. He remained convinced that Crown Point's huge water volumes and its ability through valve and storage use to minimize demand justifies a declining block rate.

Mr. Guerrettaz testified that the burden of Petitioner's frequent base rate/DSIC increases and its rate design may force municipal sale-for-resale customers to seek alternative supply options leaving Petitioner's unrecovered costs to be recovered from other customer classes. He opined these large municipal loads are of the type Petitioner should be working to retain rather than force away or "squeeze" out of business by increasing rates and harsh rate design.

Mark D. Downing, a professional engineer with Commonwealth Engineers, also submitted cross-answering testimony to respond to the testimony of Mr. Dahlstrom. He confirmed and adopted Mr. Guerrettaz's description of the Crown Point water plant and system. He emphasized Crown Point's remotely controlled solenoid water intake valve currently is set to match average daily flows, not peak flows, because Crown Point has six million gallons of storage facilities to handle its customer's peaks throughout the day. He testified that the solenoid valve is very sophisticated, well designed, and in conjunction with storage, allows far less impact on wholesale peaks than would less sophisticated systems. He testified that under appropriate terms and rates Crown Point or similarly situated sale-for-resale customers could completely close their intake valve at peak hour, rely on stored water and replenish storage post-peak. Yet despite this ability to shift consumption Crown Point is lumped with all other sale-for-resale customers in a one size fits all rate, which seems unfair to him. He suggested two rates, one for those that can minimize peak loads and one for those who cannot. He opined that to do otherwise is to overcharge those utilities that have gone to the expense and efforts to minimize peak contribution, and reward those that drive peak. Offering a lower rate for those that minimize peak demand would also create an economic incentive for other sale-for-resale customers to improve their respective plants and operations to further minimize peak demands. Such peak minimization benefits the Company and all its customers by delaying and/or decreasing demand related additions and expenses.

(e) **Schererville's Position.** Sue Sargent Haase, with London Witte Group testified in opposition to Petitioner's proposal regarding public fire protection. She testified that the Town of Schererville did not request nor has it contracted with Petitioner to provide fire protection services to customers located within the Schererville corporate boundaries or for assistance in collecting revenues to cover Schererville's own fire protection costs. Ms. Haase noted that Schererville, like other wholesale customers, maintains and flushes its own hydrants and provides the capital for fire protection within its community. Ms. Haase testified that for Petitioner to collect a fire protection surcharge from wholesale customers, it must first present evidence that the wholesale customer has specifically sought such service. Therefore, Schererville objects to paying rates to recover fire protection costs. She also testified that the proposal to move the costs of public fire protection to the base charge would subject Indiana-American's customers to additional sales tax.

(f) **Industrial Group's Position.** The Industrial Group presented cross-answering testimony by Mr. Gorman in response to the class cost allocation proposal by the OUCC. Mr. Gorman disagreed with the proposal presented by Mr. Dahlstrom to use the revised capacity factors developed by Mr. Heid. Mr. Gorman expressed his concern that Mr. Dahlstrom did not accurately apply the AWWA Rates Manual methodology with regard to the data to be used in developing the Company's capacity factors. Mr. Gorman testified that the capacity factors should be measured using many years of data to estimate load characteristics. Mr. Gorman opined that Mr. Heid's conclusion that the capacity factors he developed for this proceeding were not reliable was reasonable. Mr. Gorman agreed with Mr. Heid's proposal to use existing capacity factors and to initiate an investigation to properly estimate capacity factors.

Mr. Gorman opined that the capacity factors used by Mr. Dahlstrom cannot be used to produce an accurate cost of service study and testified that the Commission should disregard Mr. Dahlstrom's revised cost of service study as flawed and unreliable. Mr. Gorman stated that

because the OUCC's cost of service proposal was flawed, it could not be used to move the Company's rates closer to STP. Mr. Gorman also testified that even with the OUCC's proposed reduction in the Company's revenue requirement, the OUCC's proposed cost of service study results in a 15.9% increase for the industrial class, compared to a 13.1% decrease for the residential class and a system-average decrease of 4.11%. Mr. Gorman opined that the double digit-increase for the industrial class should give the Commission pause before adopting the OUCC's proposal, and testified that it was further indication that the revised capacity factors required additional study.

Mr. Gorman stated that the increase to the industrial class under the OUCC's proposal would result in rate shock for that class. He also testified that if the Commission were to adopt the OUCC's proposal to utilize the revised capacity factors, industrial rates should not be increased by more than 120% of the system-average increase. Mr. Gorman also recommended that if the OUCC's proposal were to be adopted, the Commission should limit all class increases to no more than 120% of the system-average increase in order to avoid rate shock. Mr. Gorman opined that this modest variation from the system-average increase is appropriate given the uncertain reliability of the class cost of service studies and the need to be cautious in ensuring that customers' rates are not moved further away from true cost of service.

(g) Petitioner's Rebuttal. Mr. DeBoy responded to the testimony regarding public fire protection. He testified that based on the risk of additional sales tax that would result for its customers, Petitioner is withdrawing the request to include public fire protection as a part of the base charge on the bill and will continue to show public fire protection as a separate charge. He testified that, to the extent the Commission determines that it has the discretion to move the remaining eight municipalities to a surcharge by meter size, he believes the evidence in this case supports the proposal. No municipalities responded to his letter offering them the opportunity to withdraw from the request. The only intervenor who would be subject to the request, West Lafayette, also did not oppose his request.

As to sewer rates, Mr. Heid testified that his exhibits had already identified the level of subsidies. He further testified that a sewer COSS would be of no benefit for determining the amount of the sewer subsidy and would instead simply serve to further increase the cost of sewer service.

With respect to equivalent meters, Mr. Heid testified that Mr. Dahlstrom proposed to ignore equivalent meter factors and rather retain the present level of customer charges. He noted that the equivalent meter factors had been developed many years previously and no workpapers could be located to support them. He did not believe that this would warrant simply disregarding equivalent meter factors, which had been used by this Commission for many years. Mr. Heid also testified that Mr. Dahlstrom did not explain how the COSS could be completed without the use of equivalent meter factors which are required to allocate customer-related costs. His recommendation instead was that a new equivalent meter factor study be conducted and used in the next proceeding.

As to capacity factors, Mr. Heid disagreed that the AWWA Rates Manual required that capacity factor studies be conducted every five years. The language on which Mr. Dahlstrom relied in the AWWA Rates Manual rather indicated that five years of system coincident peak

data must be reviewed but did not dictate any particular time frame for conducting capacity factor studies. Nevertheless, he considered the issue moot because Petitioner is in the process of conducting a more robust and new capacity factor study. He described the new capacity factor study as much more involved than is customarily done in connection with a capacity factor study and beyond the scope of a capacity factor study contemplated when this issue was discussed in Cause No. 43680. As explained on cross-examination, it will involve statistical sampling, the installation of new metering equipment, and analysis of the results. He described the scope as being unprecedented in Indiana.

Mr. Heid responded to Mr. Dahlstrom's objection to a portion of water mains being functionalized as a customer cost. He took issue with Mr. Dahlstrom's characterization that customer costs should be only those costs that would be avoided if the customer leaves. He noted that the *Citizens Gas Order* on which Mr. Dahlstrom relies never resulted in the actual implementation of rates. In that case, there was a dispute among the parties concerning the cost of service determination, and a subsequent settlement agreement substantially changed the result. Moreover, the settlement agreement (to which the OUCC was a party) states that "... in future proceedings, no presumption will be given to any prior cost of service or rate design methodology." Mr. Heid noted that there is no other support for Mr. Dahlstrom's position. He further explained why the Company had previously functionalized 4-inch and smaller mains to the customer cost and subsequently switched to 2-inch. The 4-inch functionalization had been in place for many years until, in the last case, Mr. Heid learned that some 4-inch mains served fire hydrants. Based on this, Mr. Heid did not allocate any small mains to the customer function in Cause No. 43680 because he had not yet had an adequate opportunity to investigate. In this case, he had conducted his investigation and determined that it would be improper to allocate 4-inch mains to the customer functions but that 2-inch mains should be so allocated. He noted that the number of feet of water mains is a function of the number of customers and that the OUCC agreed the dollar investment in water mains increased with the length of the mains. He further testified that the functionalization of a portion of mains as a customer cost is extremely prevalent in Indiana.

Mr. Heid objected to Mr. Dahlstrom's characterization of maximum-day/maximum-hour factors. He testified that there was considerable support for the derivation. Mr. Heid first determined the maximum-day/average-day coincident demand ratio by analyzing 11 years of data, which resulted in a ratio of 1.54. Mr. Heid then observed that the ratio was basically unchanged from the previous case leading him to conclude that the maximum-hour/average-day coincident demand peak ratio should remain unchanged such that the maximum-hour/maximum-day coincident demand ratio would remain in the design range of 1.4 to 1.5 as recommended by Indiana-American's Director of Engineering and hydraulic modeler. He objected to using test-year factors by Mr. Dahlstrom because the most recent year is not used for design purposes. Rather, Indiana-American's comprehensive planning reports used a 95% confidence interval for a multi-year period. He also noted that, despite Mr. Dahlstrom's objections, Mr. Dahlstrom had actually used Mr. Heid's maximum-day/average-day functional cost allocation ratio in his COSS. With respect to maximum-hour/average-day, Mr. Dahlstrom had simply prorated the functional cost allocation by the same percentage as he had proposed to modify the maximum-day/average-day function. Mr. Heid disagreed with this methodology. He stated that it is imperative to analyze both maximum-day and maximum-hour information independently and for

that analysis to be an informed analysis or judgment based on the design basis of the utility system.

Mr. Heid also responded to Mr. Dahlstrom's criticisms of residential subsidies. He noted that the residential subsidy is only 1.36% above cost of service, which Mr. Heid testified is not excessive by any definition. He noted the Commission routinely approved subsidies of this magnitude or larger, more often than not with the residential customers being the beneficiaries of subsidies by other customer classes. He found it ironic that the OUCC never supports cost-based rates when residential customers are receiving a subsidy but is now supporting cost-based rates when residential customer are providing a subsidy even at the minuscule level of 1.36%.

Mr. Heid objected to the need for a subdocket to review cost of service and rate design. He testified that it is routinely the case that a cost of service study will need to be rerun after the Commission's final order using the actual revenue requirements as found by the Commission. This will then be submitted as a part of a compliance filing. This is a routine procedure that exists in almost all cases. There is no need to commence creating subdockets for every rate case that would bifurcate every rate case into a revenue requirement phase and a cost of service allocation and rate design phase. He further noted that there would not be sufficient time during a subdocket to complete the new capacity factor study because of the intent to conduct load research.

Mr. Heid also responded to the testimony of Mr. Guerrettaz. He took issue with Mr. Guerrettaz's statement that Crown Point has consistently believed the rates and charges developed by Indiana-American are simply too high. He noted that Crown Point has never previously submitted testimony objecting to STP or the use of the capacity factors. Mr. Heid pointed to Mr. Guerrettaz's testimony submitted in Cause No. 43680, where rates for sale-for-resale customers were established on an STP basis with no declining rate block and utilizing the capacity factor which Mr. Heid used in this case. Mr. Guerrettaz submitted no testimony objecting to these aspects of the Company's proposal.

Mr. Heid disagreed with Crown Point's testimony that its system design supported a more favorable capacity factor. He noted that Indiana-American has no control over the flow control valve described by Mr. Downey. He further noted that Mr. Guerrettaz's recommendation that a 120% capacity factor be used for sale-for-resale doesn't match Crown Point's actual flows or the agreement with Indiana-American. The agreement requires Indiana-American to provide up to 6 million GPD. Using the contractual maximum would support a much higher capacity factor than the 160% proposed by Mr. Heid. He analyzed Mr. Guerrettaz's summary of flows from 2010 and 2011 and testified that if this data for 2010 were used to establish Crown Point's capacity factor it would be 205%. Using 2011 data, the capacity factor would be 256% for the nine months of data provided by Crown Point. Mr. Heid also analyzed Mr. Guerrettaz's summary of flows from 2010 taking into consideration Mr. Downey's stated concerns about weekend meter reads and still concluded that Mr. Guerrettaz's proposed 120% capacity factor was significantly understated.

Mr. Heid also objected to Mr. Guerrettaz's criticism of allocating 12-inch mains to the sale-for-resale class. He reviewed Indiana-American's system maps and conferred with Petitioner's Director of Engineering and confirmed that flow to Crown Point and other sale-for-

resale customers does in fact utilize mains as small as 12-inches. He also disagreed with Mr. Guerrettaz's exclusion of a portion of unidentified pipe. He testified a portion of the "unidentified pipe" was pipe whose size was not recorded in Indiana-American's property accounting records, while the remainder of the "unidentified pipe" was in fact other main-related appurtenances. He testified that all utilities have unidentified pipe, frequently because of its age. Moreover, all water utilities have main-related appurtenances. According to Mr. Heid, the only fair way to allocate these unidentified assets is proportionate to all identified mains.

Mr. Heid also responded to the request for a two-tiered rate design for sale-for-resale. He clarified that Mr. Guerrettaz is misconstruing the AWWA Rates Manual. The provisions on which Mr. Guerrettaz was relying are provisions concerning inverted block rate structures as opposed to declining block rate structures. An inverted block rate structure is one where the rate increases as consumption increases. If a utility attempted to use a single inverted block rate structure, this would unfairly and adversely impact large volume users such as sale-for-resale customers. This language does not mean, however, that a declining block rate structure should be utilized. According to Mr. Heid's cross-examination testimony, the declining block rate structure is established to design rates for particular customer classes. Since sale-for-resale customers have their own rate classification, a declining block structure is not needed.

Next, Mr. Heid responded to Ms. Haase's criticism that public fire protection rates should not be paid by Schererville. He clarified that the sale-for-resale class rates have not been designed to recover the direct public fire protection costs (the costs of hydrants). However, Mr. Heid noted that sale-for-resale customers require capacity on Indiana-American's system so that sale-for-resale customers can provide fire protection. These costs should be recovered from sale-for-resale customers, and Mr. Heid testified that his proposed rate design does so.

Mr. Heid responded to the testimony of Mr. Krohn. He noted that the Company had already attempted to mitigate the impact on the sale-for-resale customers with its proposed rate design. In determining which of the five Area Two districts could be moved to Area One, Mr. Heid first performed a rate design under STP. The proposed average increase to West Lafayette and Warsaw under proposed Area One rates is significantly lower than what would have occurred on a stand-alone basis and is approximately equal to full STP rates. He noted that on a stand-alone basis, Warsaw and West Lafayette would see increases far in excess of that proposed here because of new water treatment plants in both systems. That is not the case with the remaining three districts, Mooresville, Wabash, and Winchester. The proposed average increase to these operations under the proposed Area Two rates is significantly lower than full STP rates. The overall average rate increase would have almost doubled for all three districts had they been moved to full STP. Moreover, industrial customers in all three districts would have experienced significant increases with a full move to STP.

Mr. Heid testified that West Lafayette has already received mitigation as a result of STP. In Indiana-American's last rate case, West Lafayette ultimately received an overall increase of approximately 25%. On a stand-alone basis, because of the new water treatment plant which was constructed there, the increase would have been approximately 147%. In the current case, West Lafayette is receiving a larger increase of approximately 70%, but on a stand-alone basis it would have been approximately 83%. Moreover, if Indiana-American had moved fully to STP, West Lafayette would still receive an almost 68% increase.

(h) Commission Discussion and Findings.

(i) Capacity Factors. In Cause No. 43680, Petitioner and the OUCC agreed that Petitioner's capacity factor study was outdated, and we directed Petitioner to conduct and provide a new capacity factor analysis in this case. 2010 Rate Order, 2010 Ind. PUC LEXIS 155, at *305. When the Commission orders that an analysis be conducted, such as a capacity factor study, we fully expect that the information will not only be developed but will also be utilized in the next rate case. Petitioner conducted a new capacity factor analysis utilizing the methodology set forth in the AWWA Rates Manual. However, Mr. Heid testified that he did not rely on the study because the results were questionable and he deemed the study unreliable. Instead, Petitioner proposed to use the capacity factors that have been the basis of Petitioner's rates for many years.

Petitioner leaves us little choice but to rely on a capacity factor study that we considered outdated over two years ago. The OUCC presented us with an alternative capacity factor study, however, that study relies only on test-year data rather than five years of data recommended by the AWWA Rates Manual. As such, we reject the OUCC's proposed capacity factors. Mr. Heid indicated that Petitioner is currently in the process of conducting a new, more robust, capacity factor study. Before its next rate case, Petitioner shall conduct and complete a new capacity factor analysis, and shall utilize the results of the analysis in its proposed COSS. In addition, because we find that Petitioner has not complied with the 2010 Rate Order mandate to conduct and provide a new capacity factor analysis in its next rate case, Petitioner's recovery of costs associated with the COSS in this case is disallowed.

With respect to sale-for-resale, we reject Crown Point's proposal to use the same capacity factor as large industrial customers. We heard considerable evidence about Crown Point's ability to operate its systems so as to mitigate its impact on Petitioner's system. The reality is that Crown Point's flow control was not coordinated with Petitioner in terms of design or operation and is beyond Petitioner's control. We also recognize that the installation of flow control does not negate the years of planning and investment that Petitioner has made in the system to accommodate the peak demands that are experienced today. Crown Point's actual flow data does not support Crown Point's proposed capacity factors, and Crown Point has a contract which obligates Indiana-American to provide much more water than Crown Point is using. If Crown Point wishes to explore potential savings that might be produced as a result of controlling its demands on Petitioner's system, this would necessitate an amendment to the agreement between Crown Point and Indiana-American. It appears that both parties are open to have such discussions, and we encourage them to do so. Until an alternative agreement is reached, however, we will continue to utilize a capacity factor for sale-for-resale on a single tariff basis, and the existing capacity factor of 160% for sale-for-resale will be retained.

(ii) Allocation of Small Mains to Customer Costs. We have often approved the classification of a portion of distribution facilities as customer-related. These are costs that vary with the number of customers. We accept Petitioner's explanation of why this allocation was not made in the last case and why Petitioner has changed the allocation from 4-inches to 2-inches in this case. As such, we approve the allocation of mains 2-inches and smaller to the customer cost function.

(iii) Allocation of 12-Inch Mains and “Unidentified Mains.”

Based on Mr. Heid’s detailed review of the system in Northwest Indiana that delivers water to Crown Point, as well as his review of the entire system and discussions with Petitioner’s Director of Engineering, it is apparent that Petitioner does utilize mains as small as 12-inches to serve sale-for-resale customers. Accordingly, we reject Mr. Guerrettaz’s request to exclude 12-inch mains from the allocation of transmission mains costs. Mr. Heid indicated that the fairest way to allocate unidentified mains and main-related appurtenances is proportionate to all identified mains. Accordingly, we approve Mr. Heid’s allocation.

(iv) Maximum-Hour/Maximum-Day Factors Coincident Demand. Mr. Heid adequately explained how he derived the maximum-day/average-day and maximum-hour/average-day coincident demand factors. Accordingly, we approve Mr. Heid’s proposed factors.

(v) Equivalent Meter Factors. Mr. Dahlstrom rejected equivalent meter factors that this Commission has approved and utilized for many cases now. Instead, he simply maintained the existing customer charge, without any basis or support. Mr. Dahlstrom offers no alternative equivalent meter factors, nor does he explain how the COSS service study can be completed without the use of equivalent meter factors to allocate customer-related costs. We find the better course is to continue utilizing the equivalent meter factors that we have utilized previously. However, we order Petitioner to present new and meaningful equivalent meter factors in its next base rate case.

(vi) STP, Mitigation, and Subdocket Request. In terms of percentage, the increases for West Lafayette and Warsaw are large. The increases for both of these communities result partially from significant capital improvements, which were preapproved by this Commission. For example, West Lafayette’s increase results partially from a project placed in service in the last case, the cost of which was spread over the course of two rate cases. Both West Lafayette and Warsaw have benefited extensively from STP. But for STP, both of these communities would have seen rate increases on a stand-alone basis far in excess of what they will see with Petitioner’s phased approach to STP. In addition, the fact that we have authorized a 1% increase in Petitioner’s revenues, rather than the 10.48% increase Petitioner originally requested, should further mitigate the rate increases for West Lafayette and Warsaw.

We also find that the level of subsidy paid by residential customers under Petitioner’s proposed rate design is extremely small. Typically when we are addressing subsidy issues, the magnitude is many multiples of the 1.36% that results from Petitioner’s proposed rate design. While we strive for the goal of cost-based rates, we recognize that the difference results from the use of a single declining block rate structure that attempts to match revenue recovery to cost of service for four retail customer classes. We do not find the level of residential subsidy to be unreasonable.

Finally, we address the request for a subdocket. Petitioner submitted an electronic copy of its COSS pursuant to our MSFRs. Any party executing the non-disclosure agreement had access to that electronic version, and Mr. Dahlstrom agreed on cross-examination that he had an electronic copy of the COSS. The movement to STP in this case is far less dramatic than it was

in Cause No. 43680, and the size of the requested increase is substantially below that level. We fail to see why a subdocket creating a bifurcated case is necessary. Accordingly, we reject the request for a subdocket and order Petitioner to conduct and file as a part of its compliance filing a rerun of its COSS based on the inputs provided by this Order.

(vii) **Public Fire Protection.** There are three issues raised with respect to public fire protection. The first is whether surcharges by meter size can be incorporated within the base charge. Based on Ms. Haase's and Ms. Stull's testimony, Petitioner has withdrawn that portion of its request, and so we find that Petitioner should continue to show public fire protection surcharges by meter sizes as a separate item on the bill.

The second issue with respect to public fire protection is Petitioner's proposal to move the remaining eight municipalities to a surcharge by meter size. Ind. Code § 8-1-2-103 states that fire protection costs shall be included in the basic rates of all customers of the utility within the municipality if the governing body of a municipality adopts an ordinance so providing. In the 2010 Rate Order, we found that Ind. Code § 8-1-2-103 requires the governing body of a municipality to adopt an ordinance that provides that such charges shall be included in the basic rates of customers serviced by the utility within the municipality. 2010 Ind. PUC LEXIS 155, at *319-20. We denied Petitioner's proposal in that case because it did not submit adopted ordinances from the eight municipalities. *Id.*, at *320. The Commission is concerned that residents of the eight municipalities could already be paying for fire protection through taxes and would pay twice for the same service if billed directly by Petitioner. Requiring the municipalities to adopt an ordinance under Ind. Code § 8-1-2-103 provides at least some notice of this possibility to municipal residents. In this case, Petitioner has submitted proof that it notified the municipalities of its intent to bill customers directly for fire protection and indicated that no municipality objected. Tacit approval by the municipalities does not equal an adopted ordinance. Therefore, we deny Petitioner's proposal.

The final issue is whether sale-for-resale customers should pay public fire protection costs. Mr. Heid explained that his proposed rate design does not include recovery of direct public fire protection costs from sale-for-resale customers. It does, however, include recovery of costs to maintain the capacity that is necessary so that sufficient quantities of water can be delivered for sale-for-resale customers to fight fires. That is an appropriate cost to recover. As such we approve the method of recovery of cost from sale-to-resale customers.

(viii) **Sewer Rates.** If Petitioner's sewer customers paid rates based on the costs of serving them, the rates would be in excess of \$80 per month. For a very small subsidy of 3¢ per month per customer, these rates can be held at their current level of \$61.29. We agree with Mr. Dahlstrom that permanent subsidies, regardless of their size, are not the solution to rate shock for sewer customers. Therefore, we find that Petitioner's proposed subsidy shall be reduced by 50%. We also deny the OUCC's proposal that Petitioner conduct a COSS specifically for sewer service.

13. **Depreciation Rates.**

(1) **Petitioner's Position.** Petitioner proposed no general change in its depreciation rates; however it did propose a new depreciation accrual rate for its assets being

installed pursuant to its BT Project. Mr. VerDouw provided a general description of this information systems project. This project is the subject of a preapproval petition pending in Cause No. 44059. We will not repeat the description of that comprehensive project here, as the need for and appropriate ratemaking treatment of BT will be dealt with fully in that pending Cause.

The relief that Petitioner seeks in this Cause with respect to BT is the approval of a new depreciation accrual rate which would apply to the BT assets. Mr. VerDouw testified that the appropriate depreciation rate for BT is 10 years, the anticipated service life of the BT assets. He testified that Indiana-American does not have an approved depreciation rate that would encompass assets such as BT that will be useful for such a period.

(2) **OUCC's Position.** Mr. Patrick opposed the proposed depreciation rate for the BT assets. He testified that in the OUCC's view Petitioner had not adequately justified the proposed 10-year rate. He further recommended that a comprehensive depreciation study be conducted by Petitioner and filed in a separate docket at least six months prior to the filing of its next rate case. He confirmed on cross-examination that the routine practice would be for the resulting rates to become effective in that rate case. Thereafter, the OUCC recommended that Indiana-American establish a five-year cycle for reviewing depreciation rates. He testified that this was necessary given the growth in Petitioner's utility plant and service since Petitioner's last study was conducted in 2006.

(3) **Crown Point's Position.** Mr. Guerrettaz expressed concerns over the magnitude of the BT project and its timing. He urged that all issues concerning BT be dealt with in the specific BT preapproval docket.

(4) **Petitioner's Rebuttal.** In rebuttal, Mr. VerDouw responded to Mr. Patrick's disagreement with the proposed depreciation accrual rate for BT and his separate request for a five-year depreciation cycle. He noted that all Petitioner is attempting to do in this case is to match the depreciation expense for a very significant asset to its estimated useful life. He noted that if the request is not approved, the only depreciation rate that is currently available and approved would depreciate the assets over a five-year period. No party contended that the life of the BT assets would be as short as five years and Mr. VerDouw testified this is what justifies the need for a separate depreciation accrual rate. As to the proposed future timing for depreciation rates, Mr. VerDouw testified that Petitioner's current depreciation rates went into effect in October, 2007. They have only been in effect for four years. Historically depreciation studies are conducted approximately every 10 years. Mr. VerDouw noted that Mr. Patrick cites no authority suggesting a more abbreviated timetable is necessary. Depreciation studies are expensive to conduct, and conducting them more frequently would serve to increase future rate case expense.

(5) **Commission Discussion and Findings.** Petitioner does not have an appropriate, currently effective rate that applies to this asset. No party disputes that 10 years is an appropriate lifespan for the BT project. Accordingly, we approve a 10-year depreciation accrual rate for the BT project. This finding is limited to the appropriate depreciation rate for the BT project, and should not be taken as an indication of our opinion regarding the prudence of the project, which is the subject of a separate proceeding in Cause No. 44059.

14. Bonus Depreciation Deduction.

(a) OUCC's Position. Mr. Smith raised a prudence issue with regard to 2011 bonus tax depreciation. This issue does not relate to an adjustment in the current case but could influence future Indiana-American rate cases. On December 17, 2010, the President of the United States signed legislation known as the Tax Relief, Unemployment Insurance Reauthorization and Jobs Creation Act of 2010. This Act provides for 100% bonus depreciation for qualifying capital investments acquired and placed in-service after September 8, 2010, and before December 31, 2011. For 2011, American Water, including Indiana-American, opted out of the 100% bonus tax depreciation deduction. Mr. Smith testified that for a regulated public utility that normalizes its federal income tax expense, the 2011 bonus depreciation would reduce current federal income tax expense, increase deferred federal income tax expense by a similar amount and thereby increase ADIT, which would be reflected in the capital structure at zero cost. While the bonus depreciation election for 2011 will not be made until American Water files its consolidated federal income tax return in September, 2012, American Water has already made a preliminary determination that it will not elect bonus depreciation for 2011. Mr. Smith noted that American Water's explanation for opting out of 2011 bonus tax depreciation on a total group basis is that American Water may not be able to fully utilize the NOLC that would result from making the election in 2011. As to Indiana-American and the election, Mr. Smith noted that Petitioner asserted that much of its investment made in 2011 was financed with tax exempt debt and that portion would not qualify for bonus depreciation. Mr. Smith testified that Indiana-American stated in response to discovery that it is not required that all affiliates of American Water opt out of bonus depreciation on a consolidated basis but that they could make the election on an affiliate by affiliate basis. Mr. Smith's concern is that inadequate analysis has been completed on the impacts of claiming or not claiming bonus depreciation by Indiana-American. This could cause Indiana-American's ADIT balance to be lower in future cases than it otherwise might be, with the consequence that Indiana-American's future charges to ratepayers will be higher than prudent or necessary.

Mr. Smith reviewed the analysis of Petitioner's decision to not take the 100% bonus tax depreciation provided in response to OUCC discovery and the Company's explanation for why not taking 2011 bonus depreciation was prudent. Mr. Smith believes that both of those analyses suggest imprudence. By not taking advantage of the tax deduction for 2011 bonus tax depreciation, other things being equal, Petitioner will have lower ADIT and less non-investor-supplied cost free capital in its capital structure for the regulated utility in future cases.

The first analysis was conducted only at the American Water level. That analysis shows that American Water currently has a large NOLC. In making American Water's decision not to use 2011 bonus tax depreciation, the only analysis that was done in support of that decision was at the American Water, consolidated level. No analysis was done for Indiana-American or of the impact on Indiana ratepayers.

A separate analysis was conducted by Indiana-American in response to additional discovery, but that analysis ignores the time value of money. Mr. Smith explained that it is appropriate to consider the time value of money when one evaluates a projected series of cash flows. To ignore the time value of money in such an analysis is itself imprudent.

When the time value of money is considered, the Indiana-American analysis shows that ratepayers are disadvantaged by the Company's failure to take 2011 bonus tax depreciation. Mr. Smith explained that the ratepayer disadvantage results from lower Deferred Taxes. Less non-investor supplied capital in all years until the 2011 plant additions, which would have generated the 100% bonus tax depreciation applicable in tax year 2011, would have become fully depreciated for book purposes. Applying present value analysis to Indiana-American's own analysis, clearly indicates that using any discount rate other than zero, Indiana customers are adversely affected because Petitioner elected not to take 2011 bonus tax depreciation.

Mr. Smith's ultimate recommendation is that the American Water's decision not to utilize 2011 bonus tax depreciation be fully analyzed with a view to whether Indiana-American's ratepayers are harmed from American Water's decision with respect to bonus tax depreciation.

(b) **Petitioner's Rebuttal.** Mr. Warren responded to Mr. Smith's testimony. Regarding tax exempt financing, Mr. Warren testified that the issuance of tax exempt debt to finance substantial improvements in 2011 disqualified those assets from bonus depreciation. He noted that Petitioner closed on the tax exempt debt on September 16, 2010. The 100% bonus depreciation in 2011 did not become law until December, 2010. As a result, it would have been impossible to evaluate the merits of issuing tax exempt debt versus electing bonus depreciation at the time the tax exempt debt was issued. He noted that taxpayers are not required to claim the special bonus depreciation. He explained that bonus depreciation is not always in the best interest of the taxpayer. He recited a number of possible reasons why a taxpayer would elect not to claim bonus depreciation including that it would cause an existing federal NOLC to expire. American Water has concluded that it would be in the best interest of the consolidated group for no members to claim bonus depreciation with respect to any fixed assets placed in-service in 2011. Mr. Warren testified that both witnesses agree that total tax expense would be precisely the same whether or not American Water claims bonus depreciation. This is because of normalization. Further, he disputed Mr. Smith's present value analysis of the decision to claim or not claim bonus depreciation.

(c) **Commission Discussion and Findings.** This dispute is of limited significance given Petitioner's issuance of tax exempt debt at a time before the 100% bonus depreciation was available. Given that the issue has no impact on this case, we decline to make any determination on this issue.

15. Nonrevenue Water, Leaks, and Customer Complaints.

(a) **OUCC's Position.** Mr. Rees testified concerning customer complaints, leaks, and nonrevenue water. Regarding customer complaints, Mr. Rees concluded that the Company would be well served to develop a simple standard guideline for the personnel who receive and process information from the customers. He illustrated the various terms that different districts use to describe customer-reported problems, and he suggested that better consistency with this process could lead to better comparisons of the districts. In addition, he reviewed data concerning customer complaints and noted the total annual results for three of the districts (Kokomo, Southern Indiana, and Northwest) were much higher than the others: Kokomo had a total of 132 annual complaints; Southern Indiana had 304; and Northwest had 273. Mr. Rees compared these results to a benchmarking survey conducted by the AWWA.

This benchmark has values for Technical Quality Complaints per 1000 customers. Using this benchmark, Petitioner's company-wide complaint level was approximately at the median; Southern Indiana, Kokomo, and West Lafayette were above the median; and the other operations, including the Northwest district, were much lower and below the median. Mr. Rees recommended that the Petitioner review the complaints in the Southern Indiana, Kokomo, and West Lafayette operations to determine the reason for the high amount of complaints and also to develop a plan to reduce the level of Technical Quality complaints.

Mr. Rees then evaluated Indiana-American's efforts at discovering leaks. He noted that Indiana-American has taken significant steps in setting up a program that will lead to improved performance in this area but he determined that there may be a correlation between the level of customer complaints, main break data, and nonrevenue water. He suggested that the Southern Indiana leak may be the source of some of the complaints there. He recommended that the Company's larger transmission mains be surveyed regarding whether enough metering currently exists that would detect leaks sooner and what operating procedures are in place for periodic inspections. He concluded that Indiana-American has taken strides in developing a plan to improve its water leak detection; however, water leaks in the system are still occurring and probably always will.

Mr. Rees discussed the line protection services offered by American Water Resources, Inc. ("AWR"); Mr. Rees made some recommendations relative to Indiana-American's relationship to AWR and the line protection services. Mr. Rees recommended that Indiana-American require AWR to remove identification of the utility's name from all AWR customer contact and associated education/promotion materials. Mr. Rees went on to recommend that AWR report annually to its customers about its quality of service and explain what AWR customers should do if they encounter problems. Mr. Rees also recommended that Indiana-American request that AWR provide at least 120 days written notice to customers regarding any rate changes.

(b) Petitioner's Rebuttal. Mr. Hauk testified in rebuttal regarding Mr. Rees' analysis of nonrevenue water, leaks, and customer complaints. He first noted that Indiana-American takes customer complaints very seriously anywhere in its system. He noted improvements to the results from 2010 to 2011 year-to-date. Specifically, Southern Indiana has improved by 70%, Kokomo has improved by 45%, West Lafayette has improved by 22%, Northwest has improved by 17%, and overall performance has improved by 33% comparing 2011 performances to 2010. The results indicate substantial improvements in all of the districts that Mr. Rees suggested needed an improvement. For year-to-date 2011, Indiana-American, in total, was well below the median level of complaints, and all but West Lafayette of the four operations identified by Mr. Rees were below the median. Concentrating on Customer Service Complaints, another metric in the AWWA benchmark, there is even more favorable performance in the same districts that Mr. Rees highlighted. All four districts are exceeding the performance of other utilities that participated in the survey and would fall in the Top Quartile. The overall performance of Indiana-American for this indicator exceeds the Top Quartile of performance by 59%.

Mr. Hauk then responded to the nonrevenue water issues raised by Mr. Rees. He disagreed that nonrevenue water is a proper metric for evaluating a water system. Instead, the

current industry approach to better manage water loss and system performance is the application of the infrastructure leakage index (“ILI”) performance indicator. This performance indicator is an output of the International Water Association/AWWA Best Practice Water Audit Methodology developed over the period of 1997 to 2000. The ILI performance indicator gives a reliable assessment of water loss standing from operational, financial, and water resource management perspectives. A water audit is conducted for purposes of computing an ILI index, and the first water audit was completed for each of Indiana-American systems in October 2009 based on 2009 third-quarter-ending data. This data is then updated each successor quarter thereafter.

Mr. Hauk testified that the ILI is a performance indicator designed for reliable benchmarking of leakage that allows direct comparison among water utilities. Mr. Hauk presented the calculated ILI performance indicator for each of the operations. He noted that the ILI method is a significantly more robust and rigorous approach to evaluating the real losses from a distribution system than nonrevenue water. It includes as part of its analysis the cost and benefit of pursuing efforts at eliminating lost water. For example, he noted that the total production cost for all nonrevenue water per year in the Northwest Operation is \$600,000. Included within this nonrevenue water is water that is used to fight fires, water that is used internally at the treatment plants, water that is stolen, and water that escapes the system through the normal and accepted tolerances of mains and meters. While lost water should be pursued where it is cost-effective to do so, the cost of measures to eliminate lost water must be measured against the reduction in costs from producing that water. When the cost of producing non-relevant water is \$600,000, and a significant portion of that is unavoidable, one can more readily evaluate the costs and benefits of further measures. In other words, Petitioner could replace every meter, every main, every valve, and every hydrant in its Northwest Operation, and the cost savings from reduced nonrevenue water would be considerably less than \$600,000 per year. This is why it is important to consider the costs and benefits, and is part of the reason why the ILI is the industry standard today rather than simply looking at nonrevenue water as a percentage.

Mr. Hauk disagreed with Mr. Rees’ attempt to correlate nonrevenue water, main breaks and customer complaints. He noted that use of nonrevenue water fails to discern any cost benefit impacts that may financially impact customers. The ILI indicator allows utility personnel to make strategic and economic decisions from a fiscal perspective. Mr. Hauk noted that fifteen districts have seen improvements in their ILI values from the original assessment to the most recent four-quarter rolling average. Twenty have ILI values of less than five, and sixteen have ILI values of approximately three or less. He then described Indiana-American’s efforts to improve its performance in those operations with the higher ILI figures.

(c) **Commission Discussion and Findings.** Petitioner presented evidence that the issues raised by Mr. Rees have been addressed. We are satisfied that Petitioner is prudently addressing leaks and other causes of nonrevenue water through its use of the ILI index. We will expect Petitioner to continue to make strides in this regard.

16. **Confidentiality.** Petitioner filed five motions for protective order, all of which were supported by affidavits showing documents to be submitted to the Commission were trade secret information within the scope of Ind. Code §§ 5-14-3-4(a)(4), 5-14-3-9, and 24-2-3-2. The

Presiding Officers issued Docket Entries on June 9, 2011, October 18, 2011, November 2, 2011, November 22, 2011, and December 21, 2011, respectively, finding such information to be confidential on a preliminary basis, after which such information was submitted under seal. We find all such information is confidential pursuant to Ind. Code §§ 5-14-3-4 and 24-2-3-2, and is exempt from public access and disclosure by the Commission.

IT IS THEREFORE ORDERED BY THE INDIANA UTILITY REGULATORY COMMISSION THAT:

1. Petitioner is authorized to adjust and increase its rates and charges for water and sewer utility service to produce an increase in total operating revenues of approximately 1.0%. Petitioner's rates and charges shall be designed to produce total annual operating revenues of \$198,374,326, which are expected to produce annual net operating income of \$51,509,986.

2. Petitioner shall file new schedules of rates and charges with the Water/Wastewater Division of the Commission on the basis set forth in Finding No. 12. Petitioner shall simultaneously file its cost of service study and revenue proof based on the findings set forth in this Order. Petitioner's new schedules of rates and charges shall be effective on filing after approval by the Water/Wastewater Division and shall apply to water and sewer usage from and after the date of approval.

3. Petitioner's proposed depreciation accrual rate of 10% for the BT assets is approved.

4. The information filed by Petitioner in this Cause pursuant to its Motions for Protective Order is deemed confidential pursuant to Ind. Code §§ 5-14-3-4 and 24-2-3-2, is exempt from public access and disclosure by Indiana law, and shall be held confidential and protected from public access and disclosure by the Commission.

5. This Order shall be effective on and after the date of its approval.

ATTERHOLT, BENNETT, MAYS AND ZIEGNER CONCUR; LANDIS ABSENT:

APPROVED: JUN 06 2012

**I hereby certify that the above is a true
and correct copy of the Order as approved.**



Brenda A. Howe
Secretary to the Commission